

Retroactivity: The Case for Better Regulation of Federal Tax Regulators*

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I. INTRODUCTION

In his monumental work on administrative law,¹ Kenneth Culp Davis spends little time on the special area of tax regulation. Rather, he treats the area jointly administered by the Internal Revenue Service and the Treasury² as a special preserve.³ A bevy of recent cases once again reminds us that the federal courts, even the expert Tax Court, frequently act as though they share this view. These cases also illustrate the need to examine the relationship among the common law,⁴ the Administrative Procedure Act,⁵ and the Internal Revenue Code.⁶ This Article will review the often uncritical examination that courts make of regulatory actions, particularly retroactive ones, by tax authorities, and will suggest that administrative regulation in the federal tax context has become needlessly clouded by the too-ready use of inexact homilies to support judicial decisions. By failing to impose a more rational standard for review, these decisions have also virtually ceded total sovereignty to tax authorities to determine which regulatory actions are retroactive.⁷

Tradition has long viewed interpretive regulations as different from legislative regulations: interpretive regulations simply illuminate the law that has existed from the date of enactment of the statute, while legislative regulations create new law.⁸

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1. K.C. DAVIS, *ADMINISTRATIVE LAW TREATISE* (2d ed. 1978) [hereinafter DAVIS TREATISE].

2. The Internal Revenue Service [hereinafter the Service] is part of the Department of the Treasury. The Commissioner of the Internal Revenue Service [hereinafter the Commissioner] reports to the Secretary of the Treasury [hereinafter the Secretary]. The Service and Treasury have split authority in the tax arena. The Service, *inter alia*, through its various divisions, supervises reporting and collection, litigates disputes in the Tax Court, and exercises administrative agency authority to regulate; the Treasury, *inter alia*, supervises the Service, conducts analyses of tax rules, formulates policy, and recommends legislation.

3. DAVIS, *ADMINISTRATIVE LAW TEXT* § 5.01, at 124–25 (3d ed. 1972) [hereinafter DAVIS TEXT].

4. Against the background of the common law tradition of *stare decisis*, Professor Calabresi of Yale has advanced a theory of court-created sunset rules for statutes. G. Calabresi, *A COMMON LAW FOR THE AGE OF STATUTES* (1982). See *infra* text accompanying notes 68–183 for a discussion of the current pattern of judicial decisions concerning regulatory actions of the Treasury. Several courts have judicially repealed the Administrative Procedure Act in the sphere of tax regulation.

5. 5 U.S.C. §§ 551–59, 701–06, 1305, 3105, 3344, 6362, 7562 (1982) [hereinafter the Administrative Procedure Act or the APA].

6. 26 U.S.C. §§ 1-9602 (1986) [hereinafter the Internal Revenue Code or the Code].

7. Although the Service follows the notice and comment procedures of the APA, reprinted *infra* at note 12, in promulgating many new or amended regulations, if the decisions discussed *infra* (accompanying notes 119–183) represent good law, it is not required to do so.

8. Asimow, *Public Participation in the Adoption of Interpretive Rules and Policy Statements*, 75 MICH. L. REV. 521, 569 (1977) [hereinafter Asimow]. See definition of “interpretive rules” as “rules or statements issued by an agency to advise the public of the agency’s construction of the statutes and rules which it administers.” Attorney General’s Manual on the APA at 30, quoted in DAVIS TEXT, *supra* note 3, § 5.03, at 126. The same manual describes “substantive rules” as “rules, other than organizational or procedural . . . issued by an agency pursuant to statutory authority and

Because an interpretive regulation is no more than an interpretation of existing law, the common law courts have long held the view that original interpretive regulations or amendments to existing interpretive regulations may be retroactive to the date of the original legislation.⁹ This "declaratory" theory states that the regulation is an interpretation of existing law and therefore must date from the original enactment of the statute. If the regulation represents an amendment of an existing regulation, this theory necessarily commands that the earlier interpretation was incorrect and is without validity.¹⁰

But the declaratory theory is not the only parameter to guide the courts in examining the retroactive amendment or promulgation of a regulation. The courts must also look to the rules of the Administrative Procedure Act¹¹ and to the Internal Revenue Code. Section 553 of the Administrative Procedure Act requires, *inter alia*, that an administrative agency publish the final form of a regulation at least thirty days prior to its effective date.¹² The publication requirement applies generally to all

which implement the statute. . . . Such rules have the force and effect of law." *Id.* As stated by the Attorney General's Committee on Administrative Procedure, "these substantive regulations have many of the attributes of statutes themselves and are well described as subordinate legislation." Final Report 27 (1941), cited by DAVIS TEXT, *supra* note 3. Davis collects articles discussing the distinction between legislative and interpretive regulations. *Id.* at 129 n.19.

9. *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939); *United States v. California Portland Cement Co.*, 413 F.2d 161 (9th Cir. 1969) (retroactive regulation upheld); *Manhattan Gen. Equip. Co. v. Comm'r*, 297 U.S. 129 (1936) (retroactive amendment of regulation applied despite hardship). *Pollack v. Comm'r*, 392 F.2d 409 (5th Cir. 1968) (retroactive correction of prior erroneous interpretation upheld despite taxpayer's reliance to his detriment). *See also* *Dixon v. United States*, 381 U.S. 68, 79-80 (1965) (Commissioner not estopped from withdrawal of earlier acquiescence to a Tax Court decision).

10. 2 DAVIS TREATISE, *supra* note 1, § 7:23, at 109 and *infra* text accompanying notes 38-56. Yet as Nolan and Thuronyi point out:

Although this theory may be accurate in the rare case where a prior regulation was plainly erroneous, in the great bulk of cases both the original regulation and its amendment will represent an arguably permissible exercise of administrative discretion in interpreting and applying the statute. Accordingly, the original regulation cannot properly be considered a nullity.

Nolan & Thuronyi, *Retroactive Application of Changes in IRS or Treasury Department Position*, 61 TAXES 777, 783 (1983).

11. 5 U.S.C. § 553 (1982), discussed *infra* at text accompanying notes 35-37 and 57-60.

12. Section 553 provides:

§ 553. Rule making

(a) This section applies, according to the provisions thereof, except to the extent that there is involved—

(1) a military or foreign affairs function of the United States; or

(2) a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts.

(b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—

(1) a statement of the time, place, and nature of public rule making proceedings;

(2) reference to the legal authority under which the rule is proposed; and

(3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.

Except when notice or hearing is required by statute, this subsection does not apply—

(a) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or

(b) When the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made

“substantive” or “legislative” type regulations.¹³ Section 553 does not apply to interpretive regulations; they are exempt from the notice and comment provisions of the APA.¹⁴ The Internal Revenue Code (Code) contains an additional source of authority. Section 7805(b) of the Code provides that the Internal Revenue Service may designate that a regulation will *not* be retroactive.¹⁵ Although it is implicit in the wording of section 7805(b) that a regulation may be retroactive,¹⁶ section 7805(b) may be limited by section 553 of the Administrative Procedure Act requiring a thirty-day delay when substantive regulations are promulgated.¹⁷

These three sometimes competing rules have led the courts into a quagmire. This Article will examine the impropriety of the effort to remedy the unjust impact of the declaratory theory through the application of such inappropriate theories as “abuse of discretion.”¹⁸ Rather, the courts should abandon the declaratory theory in favor of more rational standards and restore the application of the APA to tax regulations.¹⁹ Treasury too should abandon the declaratory theory in promulgating

on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this subsection.

(d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—

(1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

(2) interpretative rules and statements of policy; or

(3) as otherwise provided by the agency for good cause found and published with the rule.

(e) Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.

5 U.S.C. § 553 (1982).

13. See *Wing v. Comm'r*, 81 T.C. 17, 29 n.16 (1983); 1 DAVIS TREATISE, *supra* note 1, § 3:27, at 583; DAVIS TEXT, *supra* note 3, § 5.02, at 125 *et seq.*

14. See § 553(d)(2) of the APA, *supra* note 12.

15. Section 7805(b) of the Code provides:

RETROACTIVITY OF REGULATIONS OR RULINGS—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

I.R.C. § 7805(b) (1986).

16. The existence of section 7805(b) leads to a presumption that regulations to which it applies are retroactive. *Automobile Club of Mich. v. Comm'r*, 353 U.S. 180 (1957).

17. See *infra* text accompanying notes 56–60 and 204–05.

18. When a court is sympathetic to the plight of a taxpayer, it orders nonretroactivity by turning to one or more of the elements that together comprise “abuse of discretion,” (see *infra* text accompanying notes 63–107 (“abuse of discretion” describes a collection of factors)), e.g., *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 116 (1939) (retroactivity would change settled law after implicit Congressional approval of earlier interpretation); *Iowa Power & Light Co. v. Burlington N. Inc.*, 647 F.2d 796 (8th Cir. 1981), *cert. denied*, 455 U.S. 907 (1982) (retroactive application of a new policy is disfavored when ill effects outweigh the need for immediate application or hardship outweighs public ends); *Schuster v. Comm'r*, 312 F.2d 311, 317 (9th Cir. 1962) (when result is unduly harsh to taxpayer, no retroactive effect permitted); *Shell Oil v. Kleppe*, 426 F. Supp. 894 (D. Colo. 1977), *aff’d*, 591 F.2d (10th Cir. 1979), *aff’d*, 446 U.S. 657 (1980) (where a long-established rule has been relied on, the agency should not retroactively reverse); *International Business Machs. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966) (same because of resulting inequality of treatment between competing taxpayers). But when the court is not sympathetic, the same factors are rejected; see, e.g., *Dixon v. United States*, 381 U.S. 68, 73 (1965) (Commissioner not estopped from retroactive correction even if taxpayer has relied to his detriment); *Wilson v. United States*, 588 F.2d 1168 (6th Cir. 1978) (retroactive amendment of regulation approved although litigation pending when amendment promulgated); *Pollack v. Comm'r*, 392 F.2d 409 (5th Cir. 1968) (Commissioner may retroactively correct prior erroneous interpretation despite reliance).

19. The Supreme Court rejected the declaratory theory in 1965 in *Linkletter v. Walker*, 381 U.S. 618 (1965). See also *Great N. R. v. Sunburst Oil & Ref. Co.*, 287 U.S. 358, 364–65 (1932). Thus the theory should no longer be a valid basis for analysis of tax regulations. See *infra* text accompanying notes 198–203.

tax regulations and adopt, instead, formal standards that recognize the substantive impact of many "interpretive" regulations.²⁰

II. THE COMMON LAW

Although it is easy to assume that administrative law and the deference granted to administrative agencies follows the enactment in 1946 of the APA,

[a]lmost one-third of federal peacetime agencies were created before 1900, and almost another third before 1930. The first was established by the Act of July 31, 1789, to "estimate the duties payable" on imports and to perform other related duties . . . From that day to this, Congress has been grinding out legislation creating new agencies and adding to their powers.²¹

Therefore, it is not surprising that prior to the enactment of both the APA and section 7805(b) of the Code, the courts had fashioned several precepts concerning agency regulation.²² Nor is it surprising that the courts grant great deference to the opinions of the agency charged with the administration of a particular area of law. Courts base this deference on the view that rules made by an administrative agency pursuant to a specific grant of power, if they are constitutional and issued in conformity with proper procedures, have the force of law and a court may not substitute its judgment as to the content of this type of rule, a legislative rule.²³ An interpretive rule, however, often commands the same deference, sometimes equal to the force of law, if the regulation is a reasonable construction of the statute.²⁴ It need

20. An outstanding article on the legislative impact of some "interpretive" regulations is Saunders, *Interpretive Rules with Legislative Effect: Analysis and a Proposal for Public Participation*, 1986 DUKE L.J. 288 (1986).

21. 1 DAVIS TREATISE, *supra* note 1, § 1:7, at 17.

22. Treasury regulations normally receive great weight unless they are inconsistent with the statute. *United States v. Vogel*, 455 U.S. 16, 24 (1982); *Comm'r v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948); *Fawcus Mach. Co. v. United States*, 282 U.S. 375, 378 (1931). Legislative regulations are entitled to greater weight than those issued under the authority of section 7805(a). *Fife v. Comm'r*, 82 T.C. 1, 15 (1984), as long as the agency promulgates the rule pursuant to a statutory grant of authority and in conformity with the procedural requirements imposed by Congress. *Ward v. Comm'r*, 784 F.2d 1424, 1430-31 (9th Cir. 1986); *Pullin Estate v. Comm'r*, 84 T.C. 789 (1985). In *Goodson-Todman Enterprises Ltd. v. Comm'r*, 84 T.C. 255 (1985), the court refused to blindly follow *Treas. Reg. § 1.48-8(a)(3)(iii)* (1979), which concerns the investment tax credit. The court noted that while the Commissioner enjoys broad power, he may not rewrite the statute to make it easier to administer. *Id.* at 276. Legislative regulations, however, are subject to a presumption of prospectivity only. *Greene v. United States*, 376 U.S. 149, 160 (1964); *but see United States v. California Portland Cement Co.*, 413 F.2d 161 (9th Cir. 1969) (retroactivity upheld). Interpretive regulations, in contrast, are subject to a presumption of retroactivity. *Gehl Co. v. Comm'r*, 795 F.2d 1324 (7th Cir. 1986).

23. DAVIS TEXT, *supra* note 3, § 5.03, at 126. There is a two-part test for determining if a published rule has the force and effect of law: (1) is the rule substantive and (2) did the agency promulgate the rule pursuant to a specific statutory grant of authority and in conformity with the procedural requirements imposed by Congress? *Rank v. Nimmo*, 677 F.2d 692, 698 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982), *cited in Ward v. Comm'r*, 784 F.2d 1424, 1430 (9th Cir. 1986). *See infra* note 61. A substantive rule does not have the force of law unless promulgated in harmony with procedural requirements. *Haddon Township Bd. of Educ. v. New Jersey Dept. of Educ.*, 476 F. Supp. 681 (D.N.J. 1979). But the effect of a failure to promulgate the regulation in conformity with procedural requirements may merely be delay. *Rowell v. Andrus*, 631 F.2d 699 (10th Cir. 1980) (regulation not promulgated in conformity with Chapters Five and Seven of the APA not void but effect postponed until thirty days after publication). A substantive rule is void, however, if it exceeds a specific statutory grant of authority. *Panama Ref. Co. v. Ryan*, 293 U.S. 388 (1935); conflicts with the statute. *M.E. Blatt Co. v. United States*, 305 U.S. 267 (1938); *Manhattan Gen. Equip. Co. v. Comm'r*, 297 U.S. 129 (1936); or is unreasonable. *Comm'r v. Clark*, 202 F.2d 94 (7th Cir. 1953); *Joseph Weidenhoff Inc. v. Comm'r*, 32 T.C. 1222 (1959), *acq.*, 1960-2 C.B. 7.

24. In *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939), the Supreme Court said that long-standing regulations have the force of law and are as binding on the court as the statute itself. *Accord Helvering v. Griffiths*, 318

not be the only reasonable construction of the statute.²⁵ An interpretive rule issued contemporaneously with the enactment of the statute,²⁶ or that survives a subsequent reenactment of the statute,²⁷ or that has been extant for a long period of time,²⁸ may also be granted the force of law.²⁹ This is not an unreasonable view. As the United States Supreme Court once stated:

There is no statutory provision as to what, if any, deference courts should pay to the Administrator's conclusions. . . . This Court has long given considerable and in some cases decisive weight to Treasury decisions and to interpretive regulations of the Treasury and of other bodies that were not of adversary origin.

U.S. 371 (1943); *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920); *United States v. Morehead*, 243 U.S. 607 (1917); *United States v. Grimaud*, 220 U.S. 506 (1911). But see *Helvering v. Wilshire Oil Co.*, 308 U.S. 90 (1939), in which by sleight of hand, but using technical reasoning, the Supreme Court avoided its own rule because it deemed the regulation undesirable. See also *Brown, Regulations, Reenactment, and the Revenue Acts*, 54 HARV. L. REV. 377, 377-78 (1941); and *Charbonnet v. United States*, 455 F.2d 1195, 1199 (5th Cir. 1972) ("[Treasury] regulations do not create law; they merely explain [it].").

25. The court need not find that the agency's construction is the only reasonable construction, but it must find that the agency's construction is one the court might have reached in the first instance, *i.e.*, one that is not unreasonable. *United States v. Correll*, 389 U.S. 299, 307 (1967) (an interpretive rule need only implement the statute in some reasonable manner). This is not different from the oft-repeated view that legislative rules deserve special deference, *e.g.*, *Allstate Ins. Co. v. United States*, 329 F.2d 346, 349 (7th Cir. 1964); see *Asimow*, *supra* note 8, at 566.

26. *E.g.*, *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939); *Caterpillar Tractor Co. v. United States*, 589 F.2d 1040 (Ct. Cl. 1978); but see *Bamberger v. Comm'r.*, 27 B.T.A. 785 (1933), *rev'd*, 67 F.2d 983 (10th Cir. 1933) (retroactive replacement of contemporaneous regulation upheld). In *Bingler v. Johnson*, 394 U.S. 741 (1969) (quoting *Comm'r v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948)), the Court added to the general rule that Treasury regulations should be sustained unless they are unreasonable and clearly inconsistent with the statute by declaring that a contemporaneous construction by the agency charged with administration of the statute should only be overruled for "weighty reasons." *Id.* at 750 (1969). Congress and the Commissioner, not the courts, should make appropriate adjustments to regulations. *Id.* at 750-51, quoting *United States v. Correll*, 389 U.S. 299, 306-07 (1967); *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948).

27. *United States v. Correll*, 389 U.S. 299, 307 (1967); *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).

28. *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920); *United States v. Morehead*, 243 U.S. 607 (1917); *United States v. Birdsall*, 233 U.S. 223 (1914); *United States v. Grimaud*, 220 U.S. 506 (1911).

29. Legislative regulations enjoy the full force and effect of law unless they are inconsistent with the statute, *e.g.*, *M.E. Blatt Co. v. United States*, 305 U.S. 267 (1938); are unreasonable, *e.g.*, *Joseph Weidenhoff, Inc. v. Comm'r.*, 32 T.C. 1222 (1959), *acq.* 1960-2 C.B. 7; exceed the scope of delegated authority, *e.g.*, *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935); or are issued pursuant to an unconstitutional grant of legislative authority by Congress, *e.g.*, *United States v. Grimaud*, 220 U.S. 506 (1911) (concerning the Secretary of Agriculture). "The delegation need not be 'explicit,' but it must be a delegation of power to make law. A rule that is based on such a delegation is a legislative rule, and that is the same as saying that it is 'entitled to more than mere deference or weight.'" 5 DAVIS TREATISE, *supra* note 1, § 29:20, at 421. Interpretive regulations do not share the full force and effect of law, *Estate of Boeshore v. Comm'r.*, 78 T.C. 523 (1982); *BBS Assocs. Inc. v. Comm'r.*, 74 T.C. 1118, 1132 (1980), *aff'd without publ. opin.*, 661 F.2d 913 (3d Cir. 1981), but courts grant them great deference, see Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity, A View From Within*, 43 TAXES 756, 759-60 (1976). *Couzens v. Comm'r.*, 11 B.T.A. 1040 (1928), presents the rationale for permitting retroactive revocation of published or private rulings: a taxpayer's liability should depend upon factors enumerated by Congress and applicable to all taxpayers, not upon a mistaken interpretation by one government official. *Couzens*, 11 B.T.A. 1040, 1148 (1928). This rationale commands that a changed interpretation apply to those who have received private rulings. (The Commissioner did not feel estopped by his initial private ruling in the *ITT-Hartford* case because he believed the facts submitted by the taxpayer in support of its request for the private ruling had been misstated, see *Kanter & Horwood, The ITT-Hartford Ruling Revocation: An Analysis of the Tax Implications*, 40 J. TAX'N 260 (1974); *ITT-Hartford Ruling Controversy Continues in Limelight*, 38 J. TAX'N 381 (1973)). The rationale should also protect those who have relied upon published rulings (*Automobile Club of Mich. v. Comm'r.*, 353 U.S. 180 (1957); *Manhattan Gen. Equip. Co. v. Comm'r.*, 297 U.S. 129 (1936)), and to those who have relied upon rulings issued to others (*Dixon v. United States*, 381 U.S. 68 (1965)). The Commissioner has announced, however, that he will limit his discretion to protect good faith reliance by a taxpayer on a published ruling or a private ruling issued to him. *Treas. Reg.* § 601.201(1), (5), (9) (1955). For a discussion of the retroactivity problem as it relates to revenue rulings, see Note, *Retroactive Revocation of Revenue Rulings*, 42 N.Y.U. L. REV. 91 (1967).

We consider that the rulings, interpretations and opinions of the Administrator under this [Code], while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.³⁰

In sum, the courts have repeatedly held that both legislative and interpretive regulations have obtained the force of law.

Granting long-standing regulations the force of law has not, however, made it easy for taxpayers to resist retroactive changes. Nor have constitutional arguments relating to due process succeeded. As statutes that authorize regulations may be retroactive without violating due process,³¹ so may administrative regulations, including those that are legislative in character.³² Since the standard is whether the retroactivity is reasonable, in the absence of any other guidance, each instance must be viewed on a case by case basis. In *Chock Full O'Nuts Corp. v. United States*³³ the court said: "[w]hile retroactivity in tax regulations is therefore presumptively permissible, it is in each case for the court to determine whether under all the circumstances retroactive application would be warranted."³⁴ In virtually every case the court does, in fact, decide that retroactive application is warranted. Guidance,

30. *Skidmore v. Swift & Co.*, 323 U.S. 134, 139-40 (1944).

31. See cases collected at DAVIS TEXT, *supra* note 3, § 5.05, at 133 n.1. Several recent Tax Court cases, cited in Burke, *The 1976 Retroactive Amendment of the Minimum Tax: An Exercise of the Taxing Power or a Taking of Property?*, 32 BAYLOR L. REV. 165, 166 (1980), confirm that in the view of that court retroactive enactment of an income tax is constitutional. (Mr. Burke argues that the minimum tax is an excise, not an income tax. On that ground, he states that the minimum tax enacted October 4, 1976 (Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1549 (1976)) was unconstitutionally retroactive to January 1, 1976.) See also Bryant, *Retroactive Taxation: A Constitutional Analysis of the Minimum Tax on IDCs*, 36 OKLA. L. REV. 107 (1983). Judge Bryant (Associate District Judge, Fourth Judicial District of Oklahoma, Garfield County) argues that application of the minimum tax to intangible drilling costs paid or incurred after January 1, 1976, but enacted October 20 [sic] 1976 (Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1549 (1976)) was unconstitutional because it constituted retroactive legislation prohibited by the due process clause. The Tax Court rejected Judge Bryant's view and held that retroactive application of the minimum tax provision was constitutional in *Buttke v. Comm'r*, 72 T.C. 677 (1979), *aff'd*, 625 F.2d 202 (8th Cir. 1980), *cert. denied*, 450 U.S. 982 (1981). The Tenth Circuit agreed in *Westwick v. Comm'r*, 636 F.2d 291 (10th Cir. 1980). On the constitutional aspects of retroactivity, see Novick and Petersberger, *Retroactivity in Federal Taxation*, 37 TAXES 407 (1959). While substantial authority suggests that these constitutional attacks do not succeed, e.g., *Welch v. Henry*, 305 U.S. 134 (1938); see also Report of Committee on Tax Policy, Tax Section, New York State Bar Ass'n, *Retroactivity of Tax Legislation*, 29 TAX LAWYER 21 (1975) (hereinafter Committee on Tax Policy, *Retroactivity*), some commentators have suggested that retroactive lawmaking violates our fundamental sense of fair play. See Munzer, *A Theory of Retroactive Legislation*, 61 TEX. L. REV. 425 (1982). "[R]etroactive lawmaking violates what is often called the rule of law, namely, an entitlement of persons to guide their behavior by impartial rules that are publicly fixed in advance Therefore, retroactive laws, at least those that alter the legal status of a pre-enactment action or event, are very hard to justify." *Id.* at 427.

32. The constitutional inquiry concerning retroactivity in regulations has two faces. First is the issue of ex post facto laws. Since 1798, it has been clear that the constitutional limitation on ex post facto law applies solely to criminal statutes and is not applicable to civil law or regulations. *Calder v. Bull*, 3 U.S. (3 Dall.) 386 (1798), cited by 2 DAVIS TREATISE, *supra* note 1, § 7:23, at 109. Second is the issue of legislative power. It is not clear to what extent Congress may constitutionally delegate its legislative authority to a regulatory agency. Although it is agreed that executive officers have no power to make rules and regulations without an explicit congressional grant of authority, there is disagreement on the limits of executive power acting with specific congressional authorization. To embark upon an examination of the limit is unnecessary, however. The issue here does not concern the power of the legislature to delegate substantive rulemaking power. Some delegation of substantive rulemaking is clearly constitutional; the issue is whether substantive rulemaking may be exercised retroactively.

33. 453 F.2d 300 (2d Cir. 1971).

34. *Id.* at 302-03.

however, is provided by two other sources: the Administrative Procedure Act and section 7805(b) of the Code.

III. THE ADMINISTRATIVE PROCEDURE ACT AND SECTION 7805(B) OF THE CODE

"The Administrative Procedure Act imposes minimum procedural requirements on federal regulatory agencies and governs many aspects of judicial review of the activities of these agencies."³⁵ The Administrative Procedure Act applies, *inter alia*, to the Internal Revenue Service and the Treasury Department.³⁶ It provides rules for administrative notice of most proposed rule-making to allow time for comment. It further provides that when a rule is adopted in final form, it shall not be effective for a minimum of thirty days from the date of notice.³⁷

The Internal Revenue Code has its own rule concerning agency rule-making, however.³⁸ Since long before the adoption of the Administrative Procedure Act, section 7805 of the Code (or its predecessor sections)³⁹ has provided that the Secretary of the Treasury (or his delegate) has the power to issue all "needful regulations,"⁴⁰ and since 1921 he has had the power to issue regulations without retroactive effect. The ability to issue regulations without retroactive effect implies that, in general, regulations will have retroactive effect.⁴¹ Although it may be dangerous to reason by implication when dealing with the Code, the validity of this implication rests squarely on widespread acceptance of the declaratory theory.⁴²

35. DAVIS TEXT, *supra* note 3, § 1.06, at 16.

36. Section 551 of the APA contains general definitions. Section 551(1) defines "agency" as "each authority of the Government of the United States, whether or not it is within or subject to review by another agency" The Internal Revenue Service and the Department of the Treasury are clearly within this definition. Section 551(4) defines "rule" as "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency" Section 551(5) defines "rule making" as the "agency process for formulating, amending, or repealing a rule" The Internal Revenue Service and the Department of the Treasury are both "agencies" that engage in "rule making" of "rules" covered by the APA.

37. See *supra* note 12 for the full text of section 553 of the APA. Supporters of the thirty-day requirement of § 553 say that it allows the affected public an opportunity to prepare for the rule or to take other action that the rule's adoption may necessitate. *Wing v. Comm'r*, 81 T.C. 29 (1983); see also *Rowell v. Andrus*, 631 F.2d 699, 703 (10th Cir. 1980). Others say that adoption of the notice rule requires acceptance of the efficacy of constructive notice since there is little actual notice. Because there is no wide dissemination, the Committee on Tax Policy Report suggests that the real effect is to create a period during which no governing law exists. Committee on Tax Policy, *Retroactivity*, *supra* note 31, at 24. The Report goes on to state that as a practical matter, once an announcement is made, the law is changed in a way that penalizes those who cannot hire tax counsel. *Id.* at 25.

38. The Code provides explicit statutory rules but has also led to many judicially formulated doctrines, *e.g.*, the step transaction doctrine. In this Article, the "Code" is meant to refer solely to the formal statute.

39. Section 3791 of the 1939 Code. The Code provision has existed in nearly identical form since 1921. See *infra* text accompanying notes 47-53.

40. I.R.C. § 7805(a) (1986). Section 7805(a) provides:

AUTHORIZATION—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

I.R.C. § 7805(a) (1986).

41. I.R.C. § 7805(b) (1986). See *infra* text accompanying notes 47-53.

42. See *infra* text accompanying notes 47-52.

The declaratory theory arose logically from the competing pressures of the need for administrative regulation and the view that only Congress may legislate.⁴³ Originally formulated by Sir William Blackstone,⁴⁴ the theory has flourished; the Supreme Court's prose in *Manhattan General Equipment Co. v. Commissioner*,⁴⁵ while the most famous, is but one example of the theory. The Court proclaimed that the amended regulation was retroactive:

It pointed the way, for the first time, for correctly applying the antecedent statute to a situation which arose under the statute The statute defines the rights of the taxpayer and fixes a standard by which such rights are to be measured. The regulation constitutes only a step in the administrative process. It does not, and could not, alter the statute. It is no more retroactive in its operation than a judicial determination construing and applying a statute to a case in hand.⁴⁶

By 1919 widespread acceptance of the declaratory theory dictated the almost universal view that administrative rulings were mandatorily retroactive. Because the Secretary of the Treasury accepted this theory, he believed any change in regulations forced the Commissioner of Internal Revenue to reopen "thousands of settled cases" and would lead to hardship for taxpayers who had relied upon earlier rulings.⁴⁷ He proposed legislation that would grant him power to issue rulings without retroactive effect.⁴⁸ Section 1314, the initial predecessor of section 7805, became part of the Revenue Act of 1921,⁴⁹ providing the Secretary with the discretion he desired, easing

43. Without an explicit congressional grant of authority, executive officers have no power to make rules and regulations; with it, they may act but subject to constitutional limits on the power of any agency to act "legislatively." As the Court in *Wayman v. Southard* stated: "It will not be contended, that congress can delegate to the courts, or to any other tribunals, powers which are strictly and exclusively legislative. But Congress may certainly delegate to others, powers which the legislature may rightfully exercise itself" 23 U.S. (10 Wheat.) 1, 42-43 (1825).

From the beginning of the Government, various acts have been passed conferring upon executive officers power to make rules and regulations, not for the government of their departments, but for administering the laws which did govern. None of these statutes could confer legislative power. But when Congress had legislated and indicated its will, it could give to those who were to act under such general provisions "power to fill up the details" by the establishment of administrative rules and regulations, the violation of which could be punished by fine or imprisonment fixed by Congress, or by penalties fixed by Congress, or measured by the injury done. *United States v. Grimaud*, 220 U.S. 506, 517 (1911).

44. 1 W. BLACKSTONE, COMMENTARIES *69-70.

45. 297 U.S. 129 (1936).

46. *Id.* at 135.

47. H.R. REP. NO. 350, 67th Cong., 1st Sess. 15-16 (1921). The declaratory theory engenders a difficult problem: it requires retroactivity. Uniform retroactivity would place a terrible burden on Treasury to reopen cases not barred by the statute of limitations, while administrative choice not to apply new or changed regulations to those cases still subject to audit might be viewed as a usurpation of Congress' power to tax (or exempt from tax). Thus, the Secretary felt congressional direction to be vital. Action came in 1921. See H.R. REP. NO. 350, 67th Cong., 1st Sess. 15-16 (1921). Consistent retroactivity would force the reopening of thousands of cases but "[t]he Secretary apparently felt that without the requested congressional approval, limiting rulings to prospective effect would be the equivalent of granting tax exemptions without the express authorization of Congress." Comment, *Limits on Retroactive Decision Making by the Internal Revenue Service: Redefining Abuse of Discretion Under Section 7805(b)*, 23 UCLA L. REV. 529, 532 n.19 (1976) [hereinafter *Limits on Retroactive Decision Making*].

48. Notes on the Revenue Act of 1918, p. 48-49, in J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 886-87 (1938).

49. Rev. Act of 1921, ch. 136, § 1314, 42 Stat. 227 (1921). In response to a backlog of tax cases after the First World War (See Comment, *The Scope of the Treasury's Power to Issue Nonretroactive Regulations*, 38 CALIF. L. REV. 292 (1950)), Congress adopted section 1314 of the 1921 Revenue Act. 42 Stat. 227, 314 (1921) [hereinafter the 1921 Act]. Section 1314 provided:

That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner

his administrative burdens, and protecting taxpayers who had relied upon earlier rulings.⁵⁰ That power, dictated by the declaratory theory and expanded by the Revenue Act of 1928,⁵¹ remained substantially unchanged for many years and was incorporated in the 1954 and 1986 Codes as section 7805(b).⁵²

Section 1314 as amended by the Revenue Act of 1934 became the text of section 3791(b) of the Internal Revenue Code of 1939 and section 7805(b) of the present Code. Thus, the legislative history of present Code section 7805(b) clearly shows that Congress saw the new section as a modification of the declaratory theory.⁵³

The argument that the administrative agency does not make the law, but merely interprets it, has superficial appeal. Yet, as Davis points out,⁵⁴ the inexorable logic of the declaratory rule is based upon an answer of "yes" to two questions: (1) is the rule no more than an interpretation of the statute?, and (2) is the meaning of the statute extant from the time of the statute's original enactment? It may be wrong to assume an answer of "yes" to both questions in a great number of cases.

or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

Id. The legislative history states:

Section 1002 [section 1314 of the 1921 Act] would permit the Treasury Department to apply without retroactive effect a new regulation or Treasury decision reversing a prior regulation or Treasury decision, unless such reversal is occasioned or required by a decision of a court of competent jurisdiction. This would facilitate the administration of the internal revenue laws in that it would make it unnecessary to reopen thousands of settled cases.

H.R. REP. NO. 350, Report of the Ways and Means Committee, 67th Cong., 1st Sess. 15-16 (1921); S. REP. NO. 275, Report of the Senate Finance Committee, 67th Cong., 1st Sess. 32 (1921). The Revenue Act of 1928 expanded section 1314 to allow nonretroactivity in cases where a new regulation or Treasury decision resulted from a court decision or where the new regulation or Treasury decision amended (but did not reverse) a prior regulation or Treasury decision. Rev. Act of 1928, § 605, 45 Stat. 791, 874 (1928), *see* H.R. REP. NO. 1882, 70th Cong., 1st Sess. 22 (1928). The Revenue Act of 1934 further broadened section 1314. Rev. Act of 1934, § 506, 48 Stat. 680, 757 (1934), *see* H.R. REP. NO. 704, 73d Cong., 2d Sess. 38 (1934). The amendments permitted the Secretary or Commissioner with the approval of the Secretary, to: (1) provide for nonretroactivity with respect to rulings as well as regulations and Treasury decisions; (2) permit nonretroactivity in the case of a ruling, regulation, or Treasury decision that had not been previously issued; and (3) prescribe the extent to which a ruling, regulation, or Treasury decision should be applied without retroactive effect. The hearings before the House Ways and Means Committee in 1921, as well as the Senate report on the 1934 Act, reflect a second purpose: to grant relief to taxpayers who had relied on the existing regulations and court decisions. Hearings on Revenue Revisions before the House Committee on Ways and Means, 1921, 38-39; J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 886-87 (1928); H.R. REP. NO. 704, 73D CONG., 2D SESS. 6 (1934); S. REP. NO. 558, 73D CONG., 2D SESS. 48 (1934).

50. H.R. REP. NO. 350 at 15-16; S. REP. NO. 275 at 32 (1921).

51. Rev. Act of 1928, ch. 852, § 605, 45 Stat. 791 (1928). The Conference Committee stated with respect to section 3791(b), the predecessor of section 7805(b):

[i]t is hoped that this provision will prevent the constant reopening of cases on account of changes in regulations or Treasury decisions, and it is believed that sound administration properly places upon the Government the responsibility and burden of interpreting the law and of prescribing regulations upon which the taxpayers may rely.

H.R. REP. NO. 1882, 70th Cong., 1st Sess. 22 (1928), *quoted in* *Helvering v. Griffiths*, 318 U.S. 371, 397 n.49 (1943).

52. *See infra* text accompanying notes 118-71.

53. Regulations issued without retroactive effect apparently encountered some judicial opposition initially. *See* Comment, *The Scope of the Treasury's Power to Issue Nonretroactive Regulation*, 38 CALIF. L. REV. 292, 302-08 (1950). The author also suggests that a nonretroactive regulation issued under section 3791(b) (of the 1939 Code) might be viewed as discriminatory and, therefore, a violation of the fifth amendment due process clause, but it is likely that no taxpayer would have standing to challenge the constitutionality of the regulation. *Id.* at 296. More recently, courts have suggested that a refusal to grant retroactive effect may be reviewed for abuse of discretion. *Wilson v. United States*, 588 F.2d 1168, 1172 (6th Cir. 1978).

54. DAVIS TEXT, *supra* note 3, § 5.05, at 135.

Nevertheless, the declaratory theory often continues to substitute for critical analysis, though criticized by many scholars.⁵⁵

There is no indication in the legislative history of section 7805(b) or its predecessor that Congress intended to abolish the declaratory theory. Rather, the predecessor of section 7805(b) was clearly a legislative attempt to reverse the necessary implications of the declaratory theory only in a limited sphere. Hence, the existence of section 7805(b) does not serve as a foundation for the wholesale abrogation of the declaratory theory.⁵⁶ Nor should the existence of section 7805(b) make inapplicable the APA rules for new or amended substantive regulations. The predecessor of section 7805(b) had been part of the Code for twenty-five years before the enactment of the APA. Yet, there is nothing in the APA or its legislative history that indicates Congress intended to except Treasury regulations from the broad sweep of the APA.

There is, however, incontrovertible evidence that Congress did not want to override the APA inadvertently. Section 559 of the APA provides that no subsequent statute shall overrule the APA unless the new legislation specifically states that it overrules the APA.⁵⁷ Reenactment of section 7805(b) after adoption of the APA did not overrule the APA; there is no explicit provision in any subsequent reenactment of the Code.⁵⁸ Therefore, to the extent that it is possible to classify accurately a

55. See *Limits on Retroactive Decision Making*, *supra* note 47, at 531 nn.11-13 and accompanying text, adding the author's criticism to that of Jeremy Bentham, John Austin, and Benjamin Cardozo.

56. Although the Supreme Court rejected the declaratory theory in *Linkletter v. Walker*, 381 U.S. 618 (1965) (see discussion in *Limits on Retroactive Decision Making*, *supra* note 47, at 538-39 nn.65-73), courts deciding tax cases continue to apply it. In *Charbonnet v. United States*, the court held shareholders of a former subchapter S corporation liable for investment tax credit recapture based on a retroactive regulation. The court disregarded the fact that the plaintiff had transferred his stock before the promulgation of the regulation and was no longer a shareholder when the amendment occurred. *Charbonnet v. United States*, 455 F.2d 1195, 1199 (5th Cir. 1972).

The fact that the regulation on which recapture rests was promulgated after the offending stock transfers does not change the result. Regulations do not create law; they merely explain existing legislation. Theoretically, then, we are not called upon to make the law retroactive, only the administrative agency's interpretation of it. It has been held many times, both under § 7805(b) of the Code, e.g., *Dixon v. United States*, *supra*, Pollack v. Comm'r of Internal Revenue, 392 F.2d 409 (5th Cir. 1968), and in general, e.g., *Helvering v. Reynolds*, 313 U.S. 428, 61 S.Ct. 971, 85 L.Ed. 1438 (1941), that where no limitations are imposed on Treasury regulations they are effectively retroactive. We do not hesitate to apply § 1.47-4(a)(2) retroactively, especially where the statute contained a special delegation to the Commissioner to promulgate regulations. The regulation was the first to be issued interpreting the statute, and the regulation was publicly proposed prior to the critical stock transfers.

Id. at 1199-1200 (footnotes omitted). In *Exel Corp. v. United States*, the court approved retroactive application of a regulation holding that investing in stock and other securities does not constitute a trade or business for the purpose of applying special limitations on net operating loss carryovers unless the activities historically constituted the primary activities of the corporation. Because Exel's historic business had been lumber (by then abandoned), its one and one-half year old securities business did not qualify. *Exel Corp. v. United States*, 451 F.2d 80, 84 (8th Cir. 1972).

57. Section 559 of the APA provides:

§ 559. Effect on other laws; effect of subsequent statute

This subchapter, chapter 7, and sections 1305, 3105, 3344, 4301(2)(E), 5372, and 7521 of this title, and the provisions of section 5335(a)(B) of this title that relate to administrative law judges, do not limit or repeal additional requirements imposed by statute or otherwise recognized by law. Except as otherwise required by law, requirements or privileges relating to evidence or procedure apply equally to agencies and persons. Each agency is granted the authority necessary to comply with the requirements of this subchapter through the issuance of rules or otherwise. Subsequent statute may not be held to supersede or modify this subchapter, chapter 7, sections 1305, 3105, 3344, 4301(2)(E), 5372, or 7521 of this title, or the provisions of section 5335(a)(B) of this title that relate to administrative law judges, except to the extent that it does so expressly.

5 U.S.C. § 559 (1982).

58. Congress reenacted the Code in its entirety in 1986 for the first time since 1954. Only the 1954 and 1986 Codes

regulation as substantive or interpretive,⁵⁹ history and section 559 of the APA suggest that the APA governs those regulations that are substantive while section 7805(b) governs those that are interpretive.⁶⁰

have reenacted section 7805(b) since 1946. Individual tax acts not affecting section 7805(b) are not reenactments. See *Becker v. Comm'r*, 85 T.C. 291 (1985).

59. See Asimow, *supra* note 8, at 540-41; DAVIS TEXT *supra* note 3, § 5.03, at 126.

60. Interpretation is a vital administrative function that consists of clarifying the meaning of statutes, prior regulations, case law, or other law-declaratory material. One important interpretive technique is the adoption by an agency of interpretive rules of general applicability. Interpretation also frequently occurs in the course of adjudication and through legislative rulemaking, as well as in less formal communications such as press releases, internal memoranda, or advice letters to members of the public.

Asimow, *supra* note 8, at 540-41 (citations omitted). Courts have had understandable trouble in identifying which regulations are interpretive and which are substantive. This has meant that in most cases dealing with a retroactive regulation, the court treats the regulation as interpretive, makes its analysis under section 7805(b) of the Code, and applies the standards applicable to interpretive regulations. See, e.g., *Peach v. Comm'r*, 84 T.C. 1312 (1985).

In considering the rule-making procedures of the IRS, it is necessary to distinguish between "regulations" and other rules. The familiar IRS regulations seem to be a mixture of legislative and interpretive rules, but this distinction has no procedural importance. The adoption of virtually all new or amended regulations on substantive tax matters is accompanied by prior notice and comment procedures. Thus, appellate courts concerned with the validity of IRS regulations seldom need to decide whether the regulation is legislative or interpretive.

Asimow, *supra* note 8, at 524-25. For an extensive discussion of judicial tests used to distinguish legislative and nonlegislative rules, see Asimow, *supra* note 8, at 530-52. The Fifth Circuit stated in *Anderson, Clayton*:

Strictly speaking, the question of retroactivity can arise only with respect to rules that are at least in part legislative in character. That is to say, to the extent a regulation merely interprets a statute, it in theory merely elucidates a meaning that has resided in the statute since its enactment. If an interpretive regulation merely clarifies what the language of the statute was intended to convey, it is ultimately misleading to term it retroactive. "It is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case in hand." *Manhattan General Equipment Co. v. Comm'r*, 297 U.S. 129, 135, 56 S. Ct. 397, 400, 80 L. Ed. 528, 532 (1936).

On the other hand, it seems unrealistic to suppose that many interpretive regulations merely express the one correct and intended interpretation of the statute under which they were promulgated. Many interpretive regulations will make explicit the answers to questions that Congress did not anticipate. Others will offer an answer that never crystallized during the legislative process. Professor Davis writes:[A] significant portion of what is called "interpretation" is not interpretation at all but is in truth creative law making.

Whenever interpretive rules do in fact make new law, retroactive law making should be dealt with as such, unprejudiced by the false notion that results never flow from the interpreter. Problems of retroactivity then will be solved on the basis of ideas of fairness and the necessities of practical administration.

Retroactive clarification of uncertain law ordinarily involves no unfairness. It is retroactive change of settled law, not retroactive settling of unsettled law, which may produce unjust results.

K. Davis, *Administrative Law Text*, § 5.05, 135 (3d ed. 1972).

By the same token, however, even legislative regulations must be consistent with the statute under which they were promulgated. We term them "legislative" because they are made pursuant to a specific delegation of authority and often without the particular legislative guidance typically found in statutes that spawn only interpretive regulations. But in a real sense they still interpret or explain existing legislation.

The ideal types of legislative and interpretive regulations thus quickly break down in practice. Although the distinction has considerable utility for some purposes, that one regulation is denominated legislative in character and another interpretive in character contributes little to an understanding of whether each ought to be applied retroactively.

In any event, whatever sharpness the distinction between legislative and interpretive rules might otherwise have is dulled by § 7805(a) of the Code, which authorizes the Secretary generally to prescribe all rules that enforcement of the Code requires. See *Continental Equities Inc. v. Commissioner of Internal Revenue*, 551 F.2d 74, 82 (5th Cir. 1977) (containing language that would eliminate the distinction entirely in tax cases by characterizing as legislative all regulations issued pursuant to § 7805(a)).

For purposes of determining retroactivity, at least, the emphasis should not be whether a regulation more closely resembles the legislative or interpretive ideal type, but how the new regulation stands in relation to prior law or policy.

Anderson, Clayton & Co. v. United States, 562 F.2d 972, 985 n.30 (5th Cir. 1977), cert. denied, 436 U.S. 944.

The legitimacy of substantive regulations must be judged, therefore, by standards different from the section 7805(b) inquiry. Improper adoption under the APA produces a nullity,⁶¹ while improper application of section 7805(b) leads to judicial examination of whether the retroactive application of a new or revised interpretive regulation constitutes an abuse of discretion in the limited classes of cases described in the legislative history of section 7805(b).⁶²

IV. OLDER THEORIES

It was, however, many years before the courts applied the abuse of discretion theory⁶³ to the retroactive revocation or promulgation of regulations.⁶⁴ Burdened by

61. See *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759 (1969); but see *supra* note 23; *Rowell v. Andrus*, 631 F.2d 699 (10th Cir. 1980). The APA allows review of agency action (*Heikkila v. Barber*, 345 U.S. 229, 232 (1953)) (unless the statute prohibits review; see 5 DAVIS TREATISE, *supra* note 1, § 28:5, at 272). See APA §§ 701(a) and 706.

62. Section 7805(b) authorizes the Commissioner to limit the retroactive effect of rules or regulations. See *supra* text accompanying notes 47–53. Although in many areas of the law the term “regulation” is used interchangeably with “rule” (see § 5.01 DAVIS TEXT, *supra* note 3, § 5.01, at 123), revenue (*i.e.*, published) rulings and regulations are different “animals” in tax law. Regulations have a greater force of law than revenue rulings (*Id.* § 7.01(4), at 505) and may be explained or interpreted by revenue rulings. *Id.* § 3.01, at 503. The character of a regulation as “interpretive” or “legislative” should determine the degree of “force of law.” A revenue ruling is an official interpretation by the Service, published for the information and guidance of taxpayers. Rev. Proc. 78-24, 1978-2 C.B. 503, § 3.01 at 504. A revenue ruling may be cited and relied upon in the disposition of an audit. DAVIS TEXT, *supra* note 3, § 7.01(4), at 505. Revenue rulings arise in response to a perceived need demonstrated, for example, by requests for private rulings from taxpayers, requests for technical advice from district offices, and suggestions from tax practitioner groups. *Id.* § 7.01(1) at 504. A revenue ruling generally applies retroactively unless its revocation or modification of an earlier published ruling will have adverse tax consequences for taxpayers. *Id.* § 7.01(3) at 504. Revenue rulings escape the application of section 553(d) of the APA because they are “statements of general policy . . . or practice.” [Nevertheless, Treasury ordinarily follows a notice and hearing procedure for all rules, whether interpretive or legislative. Treas. Reg. § 601.601(a)(2)–(3).] Note, *Prospective-Only Rulings under § 7805(b): Limits on IRS Discretion*, 18 STAN. L. REV. 736 (1966) [hereinafter *Prospective-Only Rulings*], focuses on twin cases in which the taxpayers demanded protection from the Service’s retroactive reversal of its position. *International Business Mach. Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966), and *Bornstein v. United States*, 345 F.2d 558 (Ct. Cl. 1965) involved private rulings on the same issue. The Service retroactively reversed both rulings. The taxpayers received opposite results in the United States Court of Claims. In the author’s view, the criteria for abuse of discretion are discrimination, reliance, and existing practice. *Prospective-Only Rulings*, *supra*, at 738–39.

63. Courts purport to determine that the retroactive effect of a new or amended regulation is an abuse of discretion. That view represents an imprecise analysis. Since section 7805(b) is an exception to the declaratory theory, it is not the retroactivity that may constitute an abuse of discretion; it is the failure of the Secretary to exercise his power under section 7805(b) to limit the effect to prospective only that may be an abuse of discretion. “Abuse of discretion” is the most successful of arguments advanced by taxpayers; however, even this argument is rarely successful and is really no more than an umbrella, applied when a court reacts to injustice but has no more explicit label. The courts have almost uniformly rejected the other theories, *e.g.*, legislative reenactment, reliance (quasi-estoppel), and discrimination, with a few very rare exceptions. See *infra* text accompanying notes 68–107. A capsule summary of alternate theories appears at *Limits on Retroactive Decision-Making*, *supra* note 47, at 533–34 n.28. The first two cases involving the abuse of discretion theory pertained to the retroactive revocation of rulings of tax exempt status: *Lesavoy Foundation v. Comm’r*, 238 F.2d 589 (3d Cir. 1956), and *Automobile Club of Michigan v. Comm’r*, 353 U.S. 180 (1957). Seventeen years later, when a court next applied the theory in *Newman v. Comm’r*, 33 T.C.M. (CCH) 219 (1974), the case concerned the revocation of a special ruling. See *Helvering v. Reynolds*, 313 U.S. 428 (1941).

64. Silence as to an effective date requires retroactive application under section 7805(b), *Dixon v. United States*, 381 U.S. 68 (1965); *Helvering v. R.J. Reynolds Tobacco Co.*, 313 U.S. 428 (1941); *Pollack v. Comm’r*, 392 F.2d 409 (5th Cir. 1968). Therefore, argues one author, silence means the Secretary did not exercise his discretion under section 7805(b). Comment, *Retroactivity and IRC § 7805 - A Plea to the IRS to Exercise its Discretion to Limit its Discretion*, 28 LOY. L. REV. 483 (1982) [hereinafter *Retroactivity and IRC § 7805*]. This is disingenuous. Moreover, the author admits that the courts have viewed silence as embodying an exercise of discretion that is, therefore, subject to review for abuse. “While retroactivity in tax regulations is therefore presumptively permissible, it is in each case for the court to determine whether under all the circumstances retroactive application would be warranted.” Chock Full O’Nuts v. United States, 453 F.2d 300, 302–03 (2d Cir. 1971), quoted in *Retroactivity and IRC § 7805*, *supra* note 64, at 491. The presumption that the exercise of discretion was legitimate is extremely strong so there is a correspondingly heavy burden

section 7805's approval of retroactivity, the courts fashioned several other avenues for non-retroactivity, including the doctrines of discrimination,⁶⁵ legislative reenactment,⁶⁶ and reliance.⁶⁷ These responses reveal the impossibility of reconciling the competing claims that the Commissioner has great discretion in the interpretation of the tax laws but that he does not make law (so that regulations may be retroactive to the date of the statute). While these competing claims make it imperative that the courts have some means to remedy outcomes that offend their basic sense of fairness, each theory the courts have used is an exception to the general rule that retroactivity is permissible. A sampling of these cases is adequate to grasp the quandary of the courts.

In 1965 the Court of Claims decided *International Business Machines Corp. v. United States*.⁶⁸ In that case, the court applied the doctrine of "horizontal equity:" the tax law should treat similarly situated taxpayers equally in the absence of a rational basis for the difference.⁶⁹ Subsequent plaintiffs, however, have failed to establish unfair discrimination on the part of the Commissioner,⁷⁰ in part because of the failure of taxpayers to demonstrate the nature of the discrimination that may result. It is first necessary to understand the impact that a change, even a prospective change, may have in order to analyze whether the impact treats similarly situated taxpayers equally. Taxpayers have failed to do so, perhaps in part because of a lack of quantitative models.⁷¹

Another theory, that of reliance, has met a similar fate. Although a number of courts have raised the question of whether reliance by a taxpayer results in a quasi estoppel against the Commissioner, taxpayers have not generally succeeded in these

placed on the taxpayer to show abuse. In other words, a court does not make its own determination of whether a regulation should be retroactive; it merely reviews the exercise of discretion made by the Secretary. "The Commissioner's action may not be disturbed unless, in the circumstances of this case, the Commissioner abused the discretion vested in him" *Automobile Club of Mich. v. Comm'r*, 353 U.S. 180, 184 (1957).

65. See, e.g., *Farmers' & Merchants' Bank v. United States*, 476 F.2d 406 (4th Cir. 1973); *International Business Mach. Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 U.S. 1028 (1966).

66. See, e.g., *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).

67. See, e.g., *Essential Communication Sys., Inc. v. American Tel. & Tel. Co.*, 446 F. Supp. 1090 (D.N.J. 1978), rev'd on other grounds, 610 F.2d 1114 (3d Cir. 1979). Cases representative of the various categories are collected in *Simpson v. United States*, 423 F. Supp. 720 (S.D. Iowa 1976), rev'd, 561 F.2d 1287 (8th Cir. 1977).

68. 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 U.S. 1028 (1966). IBM had requested and received a private ruling that its computer was not subject to excise tax. A similar private ruling had been issued to its arch-rival, Remington Rand. Two years later, the Commissioner ruled that the computer was taxable and applied the ruling retroactively to IBM, although he could not apply it to Remington Rand. (Remington Rand was protected from retroactive collection of the tax by section 1108(b) of the Revenue Act of 1926, 44 Stat. 114 (1926)). The court held, in what was clearly a case of discrimination, that the Commissioner had abused his discretion.

69. See *United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring).

70. See, e.g., *Retroactivity and IRC § 7805*, supra note 64, at 511 n.157. In *Bornstein v. United States*, 345 F.2d 558 (Ct. Cl. 1965), however, the court (in an opinion written by Cowen, C.J., the dissenter in *International Business Mach. Corp. v. United States*) found no abuse of discretion when only one of six identical corporations received a favorable ruling. In fact, discrimination is generally upheld unless there is evidence of unconscionable injury or undue hardship suffered by the taxpayer. See *Schuster v. Comm'r*, 312 F.2d 311 (9th Cir. 1962); *Lesavoy Found. v. Comm'r*, 238 F.2d 589 (3d Cir. 1956).

71. The impact of a change or addition to the regulations may be substantial even if the change is nominally prospective. See *infra* text accompanying notes 187-93 and Graetz, *Legal Transitions: The Case for Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47, 52-63 (1977) [hereinafter Graetz, *Legal Transactions*].

cases.⁷² For example, in *Garvey, Inc. v. United States*⁷³ the court rejected the plaintiff's reliance on the literal language of a regulation because the Commissioner retroactively published a different interpretation. Most successful reliance arguments have been advanced in lower courts and the rare winning case is usually not clearly more deserving than the vast array of losing ones. *Schuster v. Commissioner*⁷⁴ is an exception since the Ninth Circuit found the taxpayer's equitable interest compelling and its loss unwarranted.⁷⁵ The few winning cases have not clearly outlined the profile of a winner. Moreover, the Supreme Court has never applied the doctrine in favor of a taxpayer although the Court said in dictum in *Automobile Club of Michigan v. Commissioner*⁷⁶ that reliance by a taxpayer does not create a quasi estoppel and is not a bar to the correction of a mistake of law.⁷⁷

An analogous, but distinct, theory advanced by some taxpayers has been that of "legislative reenactment." These taxpayers have argued that Congressional reenactment of the statute has given an existing regulation the force and effect of law.⁷⁸ *Helvering v. R. J. Reynolds Tobacco Company*,⁷⁹ the leading and only Supreme Court case in which the taxpayer successfully argued the theory of legislative reenactment, involved the retroactive reversal of a regulation. Between 1921 and 1929 the R.J. Reynolds Tobacco Company periodically purchased and resold its own shares. During that period the applicable regulation provided that this type of transaction was nontaxable. Treasury amended the regulation retroactively in

72. *Manocchio v. Comm'r*, 78 T.C. 989 (1982), *aff'd*, 710 F.2d 1400 (9th Cir. 1983) (taxpayer could not rely upon a revenue ruling and a service publication that permitted deduction of certain educational benefits); *accord* *Kendel v. Comm'r*, 50 T.C.M.(CCH) 1279 (1985). The courts will not normally find that the Commissioner is estopped from a retroactive correction of a mistake of law, *Automobile Club of Mich. v. Comm'r*, 353 U.S. 180, 183 (1957); *Martins Auto Trimming, Inc. v. Riddell*, 283 F.2d 503, 506 (9th Cir. 1960). This is true even if the taxpayer has relied to his detriment, *Dixon v. United States* 381 U.S. 68, 73 (1965). The courts should apply estoppel with utmost caution and restraint, *Schuster v. Comm'r*, 312 F.2d 311, 317 (9th Cir. 1965); *Estate of Emerson v. Comm'r*, 67 T.C. 612, 617 (1977), although retroactive actions may be reviewed for abuse of discretion. *Dixon v. United States*, 381 U.S. 68, 84 (1965).

73. 726 F.2d 1569 (F. Cir. 1984), *cert. denied*, 469 U.S. 823 (1984). See also *Manocchio v. Comm'r*, 710 F.2d 1400 (9th Cir. 1983), where the court rejected taxpayer's right to rely on a revenue ruling and an IRS publication. The taxpayers in *Peach v. Comm'r*, 84 T.C. 1312 (1985), purchased a water source heat pump after the enactment of the residential energy credit provision of the Code and after studying two Service publications. *Id.* at 1313. Their pump used water at a temperature below the 15.56–18.33 degrees Celsius (60–65 degrees Fahrenheit) minimum temperature requirement set forth later (but retroactively) in *Treas. Reg. § 1.44C-2(h)* (1980). *Id.* at 1313, 1317. The court held that retroactive application was not an abuse of discretion since (1) the proposed regulation contained a 60 degree Fahrenheit requirement that served as public notice that a temperature level would be part of the definition and (2) the standards set forth in the Service publications applied to equipment, not to the geothermal deposit. *Id.* at 1318. But in *Garvey, Inc. v. United States*, the court said "reliance on the possible adoption of proposed amendments is not the reasonably justifiable conduct that is necessary to create an estoppel. As the term itself makes clear, proposed amendments are merely preliminary proposals." 1 Cl. Ct. 108, 118; 83-1 U.S.T.C. (CCH) 86, 254, 262 (1983), *aff'd*, 726 F.2d 1569 (F. Cir.), *cert. denied*, 469 U.S. 823 (1984). But see *infra* text accompanying notes 119–86. In other words, *Peach* suggests that a taxpayer should rely on proposed changes but *Garvey* says a taxpayer should not.

74. 312 F.2d 311 (9th Cir. 1962).

75. See also *Elkins v. Comm'r*, 81 T.C. 669 (1983) (evidence of unconscionable injury or undue hardship as a result of reliance prevents retroactive interpretation).

76. *Automobile Club of Mich. v. Comm'r*, 353 U.S. 180 (1957).

77. *Id.* at 183. See also *Lynn & Gerson, Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 TAX L. REV. 487, 492 n.24 (1964) [hereinafter *Lynn & Gerson*] and discussion of elements of estoppel, *Id.* at 488. *Limits on Retroactive Decision Making*, *supra* note 47, discusses at length the estoppel theory.

78. See *supra* notes 23 & 61.

79. 306 U.S. 110 (1939).

1934 although there had been no change in the underlying provision of the tax code. The Supreme Court rejected the Service's attempt to assess tax in accordance with the retroactive change in the regulations. The Supreme Court found that reenactment of the statute during the period that the regulation was in effect had given the regulation the force of law.⁸⁰ An important problem with this theory, however, is that Congress no longer reenacts each provision of the Code each year or even frequently.⁸¹

As a further ground, taxpayers have asserted that by retroactively reversing itself, the Service has abused its discretion. The great majority of these abuse of discretion cases have involved petitioners resisting retroactive changes (although the reverse is possible). In many cases, the taxpayer asserts the ground of abuse of discretion in addition to another ground for non-application.⁸² But as is made clear in *Automobile Club of Michigan v. Commissioner*,⁸³ the taxpayer bears a heavy burden to show in the particular circumstances of his case that the Commissioner has abused his discretion.⁸⁴ In 1965, with its decision in *Dixon v. United States*,⁸⁵ the Supreme Court recognized in dictum that it was possible for the Commissioner to abuse the discretion granted to him by Congress.⁸⁶ (But the taxpayer was unsuccessful in arguing that the Commissioner was estopped or had abused his discretion by

80. *Id.* at 115-16.

81. See *supra* note 57. Lynn & Gerson, *supra* note 77, at 492 n.25, examine exhaustively the then-emerging use of equitable estoppel and abuse of discretion in connection with tax controversies. The authors conclude by forecasting increased use of quasi-estoppel and, in their words, "the analogous doctrine of abuse of discretion" *Id.* at 523. They fail to recognize that "abuse of discretion" is the blanket that covers any one of a number of individual theories, each of which signifies an abuse of discretion. For example, the Tax Court has said: "[a]n abuse of discretion [in making regulations retroactive] may be found if the retroactive regulation alters settled prior law or policy upon which the taxpayer justifiably relied and if the change causes the taxpayer to suffer inordinate harm." *CWT Farms, Inc. v. Comm'r*, 79 T.C. 1054, 1068 (1982), *aff'd*, 755 F.2d 790 (11th Cir. 1985), *cert. denied*, 106 S. Ct. 3271 (1986) (citations omitted); see *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939). Moreover, the Supreme Court continues to resist finding estoppel against the government. See, e.g., *Heckler v. Community Health Servs.*, 467 U.S. 51, 62-63, 68 (sep. opin., Rehnquist, J.) (1984).

82. See, e.g., *Beneficial Life Ins. Co. v. Comm'r*, 79 T.C. 627 (1982). Some litigants have identified a fourth ground for attack: the harsh effect a change will have on a taxpayer. See, e.g., *Schuster v. Comm'r*, 312 F.2d 311 (9th Cir. 1962), in which the court approved imposition of unpaid estate taxes. The court held that the Commissioner's erroneous determination of the amount of estate tax due did not estop him from collecting from the estate's transferees. The court treated the issue of the harsh effect as part of the issue of reliance. *Id.* at 317-18. See also *Woodward v. United States*, 322 F. Supp. 332, 335 (W.D. Va. 1971), *aff'd*, 445 F.2d 1406 (4th Cir. 1971).

83. 353 U.S. 180 (1957).

84. *Id.* at 184.

85. 381 U.S. 68 (1965). *Dixon* may be viewed as a "reliance" case. In *Dixon*, the issue was the tax treatment of non-interest bearing notes issued at a discount. *Id.* at 69. A prior case, to which the Commissioner had acquiesced, had held the profit on the sale of similar notes to be capital gain. *United States v. Midland-Ross*, 381 U.S. 54 (1965). The plaintiffs unsuccessfully argued that because of their reliance the Commissioner was estopped from repudiating his earlier position and charging them with ordinary income. *Dixon*, 381 U.S. 68, 70 (1965). The district court recognized the harsh effect on the plaintiffs but said that the law is clear: the Commissioner may correct a mistake of law even when a taxpayer has relied to his detriment. See *Dixon v. United States*, 224 F. Supp. 358, 362 (S.D.N.Y. 1963), *aff'd*, 333 F.2d 1016 (2d Cir. 1964), *aff'd*, 381 U.S. 68 (1965). The Court refused to apply the abuse doctrine because the taxpayer failed to demonstrate justifiable reliance. *Id.* at 362-64. "Abuse of discretion" may not constitute a separate ground for non-retroactivity but is, rather, the product of the Commissioner's refusal to recognize some other argument, e.g., discrimination, reliance. *Dixon v. United States*, 381 U.S. 68, 80 (1965). The taxpayer had relied upon an acquiescence published in the Internal Revenue Bulletin. *Id.* at 70.

86. *Id.* at 80.

retroactively revoking an acquiescence.⁸⁷) Of course, the Court did not imply that the Commissioner could be prevented from changing his view retroactively.

Nor has the Supreme Court ever found an abuse of discretion in a tax case. It has, however, seemingly approved the theory by rejecting on the facts its application in *Dixon v. United States*⁸⁸ and *Automobile Club of Michigan v. Commissioner*.⁸⁹ In *Lesavoy Foundation v. Commissioner*,⁹⁰ the Third Circuit barred the Commissioner from revoking retroactively a private ruling⁹¹ (unpublished)⁹² that had been granted to a charitable foundation finding that it was entitled to a tax exemption. A retroactive revocation would have compelled the foundation to exhaust its capital in order to pay back-taxes. The Third Circuit held that the retroactive change by the Commissioner would constitute an abuse because it would impose such harsh results on the taxpayer.⁹³

Taxpayers have successfully asserted abuse of discretion in a few lower court cases. For example, in *Simpson v. United States*⁹⁴ the taxpayer successfully argued that the Commissioner had abused his discretion by retroactively applying Treasury Regulation section 1.1361-16. That regulation held that repeal of section 1361 of the Code which resulted in termination of the taxpayer's section 1361 election should be treated as a corporate liquidation. Finding that Congress had not granted authority to Treasury to prescribe the tax effect of the termination by law of the taxpayer's section 1361 election, the court held the regulation invalid.⁹⁵ It appears that an abuse of discretion was present only because the regulation was more legislative than interpretive in character.⁹⁶

Then, in 1977, in *Anderson, Clayton & Co. v. United States*,⁹⁷ the Fifth Circuit sought to apply the abuse of discretion theory and listed a number of factors necessary for application of the doctrine:⁹⁸

87. *Id.* at 76. Since 1925, the Commissioner has published his acquiescence or nonacquiescence to some adverse decisions by the Tax Court (or its predecessor, the Board of Tax Appeals).

88. *Id.* at 75-80.

89. 353 U.S. 180, 184-86 (1957). See also *Dickman v. Comm'r*, 465 U.S. 330, 353 n.11 (1984) (J. Powell, dissenting); *Central Ill. Pub. Serv. Co. v. United States*, 435 U.S. 21, 39 (1978) (Powell, J., concurring).

90. 238 F.2d 589 (3d Cir. 1956).

91. A private ruling is "a written statement issued to a taxpayer or his authorized representative by the National Office [of the Service] which interprets and applies the tax laws to a specific set of facts." Treas. Reg. § 601.201(a)(2) (1955). A private ruling applies only to the requesting taxpayer and may not be cited or relied upon by any other taxpayer. I.R.C. § 6110(j)(3) (1986).

92. See *Central Ill. Pub. Serv. Co. v. United States*, 435 U.S. 21 (1978); *Essential Communication Sys., Inc. v. American Tel. & Tel. Co.*, 446 F. Supp. 1090 (D.N.J., 1978), *rev'd on other grounds*, 610 F.2d 1114 (3d Cir. 1979).

93. *Lesavoy Found. v. Comm'r*, 238 F.2d 589 (3d Cir. 1956).

94. 423 F. Supp. 720 (S.D. Iowa 1976), *rev'd*, 361 F.2d 1287 (8th Cir. 1977).

95. *Id.* at 731-32.

96. In *Pullin Estate v. Comm'r*, 84 T.C. 789 (1985), the Tax Court considered the validity of Treas. Reg. § 20.2032A-8(c)(2)(1980), that requires the surviving tenants-in-common to consent to use an estate valuation based on a special use of the property although the surviving tenants-in-common could not affect the disposition of the decedant's interest. Again, the taxpayer appears to have succeeded only because the regulation was more legislative than interpretive in character. *Stephenson Trust v. Comm'r*, 81 T.C. 283 (1983), also finds a regulation invalid. That case concerned Treas. Reg. § 1.641(a)-0(c), T.D. 7204, 1972-2 C.B. 352, 393, which requires multiple trusts to be treated as one trust. Again, the regulation was more legislative than interpretive in character. But see *Schaefer v. Comm'r*, 46 T.C.M. (CCH) 986 (1983), in which the Tax Court upheld retroactive application of Treas. Reg. § 1.661(a)-2(e), T.D. 7287, 1973-2 C.B. 210, that taxes amounts paid by an estate to a widow pursuant to a court order, which appears equally legislative in character.

97. 562 F.2d 972 (5th Cir. 1977), *cert. denied*, 436 U.S. 944 (1978).

98. 562 F.2d 972, 981 n.19 (1977). The court emphasizes that this list is not exclusive.

- (1) the extent to which the taxpayer relied justifiably on settled prior law that was changed by the regulation;
- (2) the extent to which prior law has been implicitly approved by Congress;
- (3) the extent to which retroactivity would advance or frustrate the interest of treating similarly situated taxpayers equally; and
- (4) the extent to which retroactivity will produce an inordinately harsh result.

The Fifth Circuit's formulation of the factors necessary to find an abuse of discretion reveals finally that "abuse of discretion" is not a separate theory.⁹⁹ Rather, it is a collective phrase that encompasses each of the elements that have been treated as independent theories by various courts and commentators. The first factor listed by the Fifth Circuit constitutes the reliance theory,¹⁰⁰ the second the reenactment theory, the third the discrimination theory,¹⁰¹ and the fourth the harsh effects theory.¹⁰² As previously noted, taxpayers have been generally unsuccessful with each of the theories although "reliance" and "discrimination"¹⁰³ have perhaps fared better than "reenactment."¹⁰⁴ The harsh effects attack has never succeeded.¹⁰⁵ There have been few successful cases on any theory, and the Fifth Circuit's formulation suggests that only a combination of all four factors may succeed.¹⁰⁶

99. While the courts do not always classify their analyses into one of these branches, a review of their reasoning suggests that it is not inappropriate to do so.

100. The theory of justifiable reliance is viewed as a separate theory in *Retroactivity and IRC §7805*, *supra* note 64. The author states that the theory evolved from various rules announced by courts in support of the Commissioner, rather than from prior law or cases. *Id.* at 502-03.

101. Although "discrimination" as a separate theory has a superficial appeal, abuse of discretion may well be the only regulatory behavior that creates an actionable discrimination. *See* text accompanying notes 68-71. Lynn and Gerson, *supra* note 77, at 512 (discrimination is a branch of abuse of discretion directed toward a particular taxpayer).

102. The fourth factor, inordinately harsh results, has not constituted a separate theory but has been noted in connection with other factors. *See, e.g.,* Weaver, *Retroactive Regulatory Interpretations: An Analysis of Judicial Responses*, 61 NOTRE DAME L. REV. 167 (1986). *Madorin v. Comm'r*, 84 T.C. 667 (1985), concerns example five of Treas. Reg. § 1.1001-2, promulgated December 11, 1980, T.D. 7741, 1981-1 C.B. 430, 431. The petitioners argued that it was improper for the new example to apply to a trust perfected in 1978. *Madorin v. Comm'r*, 84 T.C. 667, 680 (1985). The Service argued that the example merely set forth the long-standing ruling and litigation position of the Service that had been published in 1977. *Id.* After reviewing *Automobile Club of Mich. v. Comm'r*, 353 U.S. 180 (1957), *Beneficial Life Ins. Co. v. Comm'r*, 79 T.C. 627 (1982), (regarding abuse of discretion) *Helvering v. R.J. Reynolds' Tobacco Co.*, 306 U.S. 110 (1939), *Wilson v. United States*, 588 F.2d 1168, 1172-73 (6th Cir. 1978), (regarding reliance), the court held that there was no abuse of discretion by the Commissioner and no reliance by the taxpayer. *Id.* at 681. The court said that the Secretary's failure to limit the retroactive effect of a regulation may not be disturbed unless it amounts to an abuse of discretion. The court cited *Wendland v. Comm'r*, 79 T.C. 355 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir. 1984), *aff'd sub nom. Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir.), *cert. denied*, 469 U.S. 1034. *Id.*

103. *See Limits on Retroactive Decision Making*, *supra* note 47, discussed *infra* at note 106.

104. Courts have uniformly rejected the reenactment theory. *See supra* notes 78-81 and accompanying text. *See United States v. Cocke*, 399 F.2d 433 (5th Cir. 1968), *cert. denied*, 394 U.S. 922 (1969); *Gulf Inland Corp. v. United States*, 570 F.2d 1277 (5th Cir. 1978). *But see Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).

105. The Supreme Court approved the doctrine of manifest injustice as a basis for nonretroactivity of a statute in *Bradley v. School Bd. of Richmond*, 416 U.S. 696 (1974). The Court set out three factors for application of the doctrine: (1) the nature and identity of the parties, (2) the nature of their rights, and (3) the nature of the impact of a change in law on those rights. *Id.* at 717. Other courts have applied the doctrine to statutory changes, *see, e.g., Iowa Power & Light Co. v. Burlington N., Inc.*, 647 F.2d 796 (8th Cir. 1981), *cert. denied*, 455 U.S. 907 (1982) (the Interstate Commerce Commission Act). No court has applied the doctrine favorably for a taxpayer in a retroactive regulation context.

106. *But see Lesavoy Found. v. Comm'r*, 238 F.2d 589 (3d Cir. 1956). The case might be viewed as illustrating the "quasi-estoppel" doctrine. Lynn and Gerson, *supra* note 77, remains the authoritative article on the subject of estoppel; *see also* Note, *The Emerging Concept of Tax Estoppel*, 40 VA. L. REV. 313 (1954). The author in *Limits on Retroactive Decision Making*, *supra* note 47, concludes that courts should adopt the same criteria for regulations as they use to determine whether a judicial decision will be limited to prospective effect. *Id.* at 548. The author suggests that the three elements of *Linkletter v. Walker*, 381 U.S. 618 (1965)—purpose, effect, and reliance to detriment—are the appropriate ones. *Limits on Retroactive Decision Making*, *supra* note 47, at 542.

Furthermore, if the criteria stated by the Fifth Circuit in *Anderson, Clayton* become universal, it will be difficult to challenge successfully the retroactive application of a new or amended interpretive regulation. The first factor set forth by *Anderson, Clayton* is the existence of a settled rule of law. If the regulatory action is interpretive, there can be no contrary "settled" rule of law since the Commissioner may always correct an erroneous interpretation (his or the public's),¹⁰⁷ and an erroneous interpretation cannot be a "settled" rule of law.¹⁰⁸

While the broad grant of congressional authority to the Secretary in section 7805(b) makes necessary some standard for review by the courts,¹⁰⁹ it appears that each of the standards advanced is really part of abuse of discretion as explained by the *Anderson, Clayton* court.¹¹⁰ Moreover, *Anderson, Clayton*¹¹¹ probably goes as far as possible to lay down standards to govern the competing claims that the Service has great discretion but that the Commissioner does not make law.¹¹²

In contrast to section 7805(b)'s requirement that non-retroactivity requires explicit action, the APA requires prospectivity. Since the Administrative Procedure Act requires advance warning (prior to application) for most rules,¹¹³ the issue of its relationship to section 7805(b) of the Code is inevitable. Section 553(b)(3)(A) of the

107. Indeed, in *CWT Farms v. Comm'r*, 79 T.C. 1054 (1982), *aff'd*, 755 F.2d (11th Cir. 1985), *cert. denied*, 106 S. Ct. 3271 (1986), the Tax Court approved the retroactive application of original regulations that varied from rules previously announced by the Service in the "DISC Handbook," 79 T.C. 1054, 1067-70 (1982). The "DISC Handbook," *A Handbook for Exporters*, U.S. Treasury Dept., January 24, 1972. Although the DISC Handbook stated that it could be relied upon until regulations were proposed, *Id.* at 1, 10, the Tax Court upheld the retroactive application of the new regulation. The court found that the Handbook could not bind the Treasury to prospective application of the new regulation and that, in any event, the taxpayer had received sufficient notice from the proposed regulation published prior to the tax year involved. *CWT Farms v. Comm'r*, 79 T.C. 1054, 1056 (1982). *But see* *Gehl Co. v. Comm'r*, 795 F.2d 1324 (7th Cir. 1986) (retroactive application of the DISC regulation constitutes an abuse of discretion because the DISC Handbook promised no retroactive change). The same circuit upheld retroactive application of a 1978 change to section 2035 of the Code. The change made the value of certain life insurance policies transferred prior to death includible in the transferor's gross estate for estate tax purposes. *Elkins v. Comm'r*, 797 F.2d 481 (7th Cir. 1986).

108. *See supra* note 85. A substantive regulation should, by its nature (even under current law), be prospective only. Therefore, the issue of the "settled rule of law" factor will not arise in regard to substantive regulations.

109. The courts may view cases involving special factors in a different manner. For example, courts may permit the application of a retroactive regulation issued while litigation is pending, but subject the validity to a higher standard. In *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971), the Second Circuit stated that the Commissioner may not promulgate a retroactive regulation during the course of litigation to arm himself with a defense. *Id.* at 303. Thus, although a retroactive regulation issued pending or during litigation is not automatically abusive, it may be viewed differently. Of course, this may mean that the sole reason for the application of a different standard is the date a taxpayer gets to court. Abuse of discretion may also apply differently when the issue is publication after the time expires during which a taxpayer may make a required election or take a required action. In *Continental Bank v. United States*, 517 F. Supp. 918 (E.D. Pa. 1981), *aff'd*, 688 F.2d 819 (3d Cir. 1982), the court rejected the application of a retroactive regulation containing a deadline impossible for the taxpayer to meet.

110. *See supra* text accompanying notes 99-106.

111. *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 981 (1977).

112. *But see* *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939); *Lynn and Gerson*, *supra* note 77, at 492-93 n.26. As Davis states:

If interpretive rules were always merely interpretations of law that already exists, they could never be retroactive, for if they fail to reflect the true meaning of the law they interpret, they would be invalid for that reason, and if they reflect that meaning they do not make law retroactively. The obvious reality is, of course, that what is done in the name of interpretation often adds to the meaning that is already in what is interpreted; for instance, the Supreme Court obviously makes law when it overrules its own prior decisions interpreting due process.

2 DAVIS TREATISE, *supra* note 1, § 7:23, at 112.

113. *See supra* note 36.

APA¹¹⁴ exempts from the rule of prospectivity interpretive rules and general statements of policy.¹¹⁵ One view, therefore, is that section 7805(b) applies solely to those interpretive rules and general statements of policy that are not otherwise subject to the Administrative Procedure Act. If that is the case, there are still several problems in the area of tax regulation. First, there is the difficulty of identifying those regulations that are merely interpretive. Second, there is the question of the propriety of the Treasury regulating its own authority, given the tendency of courts to grant too much autonomy to the Treasury Department official who makes the decision in any given case.¹¹⁶ Third, there is the issue of what standard the Treasury should apply in exercising its discretion under section 7805(b).¹¹⁷ But there is no agreement that

114. Section 553 of the APA appears *supra* note 12.

115. 5 U.S.C. § 553(b)(3)(A) (1982). For a discussion of the "good cause" exemptions, see 1 DAVIS TREATISE, *supra* note 1 § 6:29, at 590-93.

116. Treasury regulations must be sustained unless they are unreasonable and plainly inconsistent with the statute, *Comm'r v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948), and they are binding on both the Service and the taxpayer, e.g., *Lansons, Inc. v. Comm'r*, 622 F.2d 774, 776 (5th Cir. 1980); *Mutual Sav. Life Ins. Co. v. United States*, 488 F.2d 1142, 1145 (5th Cir. 1974); *Miller v. Comm'r*, 333 F.2d 400, 403 (8th Cir. 1964). But these maxims ignore the differences among types of regulations. There are three types of regulations: legislative, interpretive, and procedural. (Williams, *Preparation and Promulgation of Treasury Department Regulations Under I.R.C. of 1954*, 1956 So. CAL. TAX INST. 733 (1956), suggests that the 1954 Code introduced a fourth: a regulation prescribed by the Code for issuance by Treasury. He cites the 1954 Code's direction that "regulations shall be prescribed by the Secretary . . . corresponding to the regulations . . . which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress." *Id.* at 742 (quoting section 263(c) of the 1954 Code). The Deficit Reduction Act of 1984, Pub. L. No. 98-369, section 79(a) contains a similar provision which provides, "Section 752 of the Internal Revenue Code of 1954 (and the regulations prescribed thereunder) shall be applied without regard to the result reached in the case of *Raphan v. United States*, 3 Cl. Ct. 457 (1983)." (Emphasis added).

117. The standards for review of substantive and interpretive regulations are, or should be, different. The legislative history of the APA indicates (see Asimow, *supra* note 8, at 533 n.55) that one reason Congress did not include interpretive rules in the pre-adoption requirements of the APA was its perception that these rules would be subject to plenary judicial review. As Congress understood the difference in 1946, interpretive rules were an agency's legal opinion as to which a court was free to substitute its judgment. Legislative rules, on the other hand, could only be overturned if they were arbitrary or capricious and not rationally related to the purpose of the underlying statute. (Asimow, *supra* note 8, at 563 and n.193). Review for "arbitrary and capricious" action appears to inquire whether an administrative action was rational. See 2 DAVIS TREATISE, *supra* note 1, § 9:07, at 248-56. For example, in *Motor Vehicle Mfrs. Assn. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), the Supreme Court found that the National Highway Traffic Safety Administration's rescission of its proposed airbag regulation was arbitrary and capricious because the agency had failed to adhere to its own standards. (The Court remanded for the agency to adhere to the standards or amend the standards to constitute ones that the agency's analysis would support.) In *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971), the agency's action was arbitrary and capricious. The Court said that its responsibility in reviewing agency action is not to do a *de novo* review but to make a substantial inquiry to determine if the Secretary considered the relevant factors in reaching the decision and had followed the procedural requirements. But an agency's refusal to exercise its authority is not an abuse and is not reviewable. *Heckler v. Chaney*, 470 U.S. 821, 831 (1985). While an "abuse of discretion" suggests a rational choice improperly made, "arbitrary and capricious" suggests an irrational error of judgment. As time has passed, however, the standard for interpretive (as well as substantive) rules has become "abuse of discretion." Davis suggests, however, that abuse of discretion is no longer the standard for interpretive regulation. Chapter seven of the APA covers review of agency action. Section 701 is entitled "Application; Definitions;" section 706 is entitled "Scope of Review." Davis concludes that combining sections 701(a) and 706 produces a rule that should read: "[t]his chapter applies . . . except to the extent that . . . agency action is committed to agency discretion by law. . . . The reviewing court shall . . . set aside agency action . . . found to be . . . an abuse of discretion" 5 DAVIS TREATISE, *supra* note 1, § 28:6, at 276. Davis argues that the

"literal language [of the APA] seems to say that the court shall set aside an abuse of discretion except so far [as] the agency has discretion; the exception seems to consume the whole power of the court, so that when the agency has discretion the court may not set aside an abuse of discretion. Furthermore, the statutory words clearly imply that agency action found to be an abuse of discretion may not be set aside when agency action is by law committed to agency discretion."

Id. at 275. See *infra* text accompanying notes 191-96 (standards); Weaver, *Retroactive Regulatory Interpretations: An Analysis of Judicial Responses*, 61 NOTRE DAME LAW REV. 167 (1986).

section 7805(b) applies only to regulations that fall within the section 553(b)(3)(A) exemption of the Administrative Procedure Act.¹¹⁸

Although the issue of the interaction of the Code and the APA did not arise until very recently, at least two courts, the Claims Court and the Tax Court, have held that section 7805(b) overrides the Administrative Procedure Act.¹¹⁹ If this view is correct, the Administrative Procedure Act does not require that even substantive Treasury regulations be prospective only. If this view is correct, the Administrative Procedure Act is irrelevant and inapplicable to any regulatory action by the Treasury Department. The better view, however, reconciles the APA with section 7805(b); the better view, as suggested *infra*, makes the Administrative Procedure Act applicable to all regulations other than those clearly excluded by section 553 of the APA and makes section 7805(b) applicable only to clearly interpretive regulations and general statements of policy. Other issues remain, however.

V. THE TAX COURT ENCOUNTER

In two recent cases,¹²⁰ the Tax Court discussed for the first time the relationship between section 7805(b) of the Internal Revenue Code¹²¹ and section 553(d) of the Administrative Procedure Act.¹²² These cases involved the same retroactive amendment to existing Treasury Regulation section 1.612-3 concerning advanced mineral royalty payments.¹²³ Together, these cases illustrate in microcosm the interaction of the Treasury and the courts in the area of administrative regulation.¹²⁴

118. In *Kaiser Cement Corp. v. United States*, 8 Cl. Ct. 34, (1985), a case concerning a change in a regulation regarding the tax year of a controlled foreign corporation, the Claims Court specifically found that section 7805(b) overrides the APA, *id.* at 40, although the predecessor of section 7805(b) was extant at the time of passage of the APA and there is nothing in the legislative history of the APA indicating Congress' intent to carve an exception for Treasury regulations from the regular scheme. At least two Tax Court cases concerning Treas. Reg. § 1.612-3 agree; many others impliedly agree. But *Redhouse v. Comm'r* (the Ninth Circuit review of *Wendland*), 728 F.2d 1249 (9th Cir.), *cert. denied*, 469 U.S. 1034, (1984)), held that the change was not subject to the APA because the rule was merely interpretive. 728 F.2d 1249, 1253 (1984). See discussion *infra* at text accompanying notes 120-52.

119. The Claims Court case is *Kaiser Cement v. United States*, 8 Cl. Ct. 34 (1985). The Tax Court cases are *Wendland v. Comm'r*, 79 T.C. 355 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir. 1984), *aff'd sub nom.* *Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir.), *cert. denied*, 469 U.S. 1034 (1984); and *Wing v. Comm'r*, 81 T.C. 17 (1983). *Wendland* was appealed to both the Ninth and Eleventh Circuits. The Ninth Circuit stated that the notice requirement of the APA would give way to the Code in any conflict; see text accompanying note 147. The court went on to hold, however, that the amended regulation under consideration was interpretive rather than substantive. 728 F.2d 1249, 1253 (1984). Therefore, its view is dictum. The Eleventh Circuit adopted the view of the Ninth Circuit, presumably including the dictum. But see 739 F.2d 580, 582 (1984). *Lugo v. Miller*, 640 F.2d 823 (6th Cir. 1980) (section 7805 and the APA co-exist); *Southern Pac. Trans. Co. v. Comm'r*, 75 T.C. 497 (1980) (APA applies to substantive regulations). See also *Long v. United States*, 10 Cl. Ct. 46 (1986). The court in *Long* says that in *Redhouse* the Ninth Circuit deemed the 1977 amendment in proposed and final form as interpretive because the 1977 amendment revoked two erroneous interpretations of the 1960 regulation by revoking two revenue rulings. *Id.* at 52 n.2. (See *Ward v. Comm'r*, 784 F.2d 1424, 1430 (9th Cir. 1986)); *Redhouse v. Comm'r*, 728 F.2d 1249, 1250 (9th Cir.), *cert. denied*, 469 U.S. 1034 (1984)). But *Redhouse* recognized that the 1960 regulation was substantive; therefore, its replacement must also be substantive.

120. *Wendland v. Comm'r*, 79 T.C. 355 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir. 1984), *aff'd sub nom.* *Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir. 1984), *cert. denied*, 469 U.S. 1034 (1984); and *Wing v. Comm'r*, 81 T.C. 17 (1983).

121. See *supra* note 15 for text of section 7805(b).

122. See *supra* note 12 for text of section 553.

123. *Kaiser Cement Corp. v. United States*, 8 Cl. Ct. 34 (1985), was not a mineral royalty case.

124. The indirect source of some of the confusion in these mineral royalty cases may lie with a misreading of *Anderson, Clayton & Co. v. United States*, 562 F.2d 972 (5th Cir. 1977), *cert. denied*, 436 U.S. 944 (1978). *Anderson, Clayton* dealt with Treas. Reg. § 1.902-3(d)(1) (1975). That regulation, adopted on October 2, 1975 but retroactive to

A. Preview

An advanced minimum mineral royalty is a royalty payment¹²⁵ made at the outset of a lease or at the outset of each new lease term. It is usually a multiple of the royalty due per unit of mineral and is generally nonrefundable. Prior to its amendment, Treasury Regulation section 1.612-3(b)¹²⁶ permitted the payor to elect to deduct the payment either in the year paid or accrued or in the year the minerals to which the payment related were sold. Prior to amendment, Treasury Regulation section 1.612-3(b) provided as follows:

(b) Advanced royalties.

(1) If the owner of an operating interest in a mineral deposit . . . is required to pay royalties on a specified number of units of such mineral . . . annually whether or not extracted . . . within the year, . . .

1962, provides a method for determining the source of income of a domestic corporation's foreign subsidiary. Identity of the source is important for determining the per country limitation for the foreign tax credit. The Fifth Circuit first noted that a legislative regulation has the force of law: "[i]nsofar as the regulation may be characterized as a legislative rule, it is as binding on a court as a statute." *Id.* at 976 (citations omitted), citing DAVIS TEXT, *supra* note 3, § 5.03. "The treatment of legislative and interpretive rules in §§ 7:8-7:13 [of the DAVIS TREATISE] makes clear that valid legislative rules have about the same effect as valid statutes and are therefore binding on courts, but that the courts in varying degrees refrain from substituting judgment as to content of interpretive rules." 5 DAVIS TREATISE, *supra* note 1, § 29:20, at 421. See also Asimow, *supra* note 8. Because of the difference in impact, courts nearly always defer on interpretive regulations, but they are becoming more searching when reviewing legislative ones. Asimow, *supra* note 8, at 563-65.

A distinction similar to that between legislative and interpretive rules may become significant with regard to retroactivity when a new regulation alters an existing regulation promulgated under a statute that Congress has reenacted. The party seeking to escape retroactive application of the new regulation will argue that *Helvering v. R.J. Reynolds Tobacco Co.*, *supra*, 306 U.S. 110, 59 S. Ct. 423, 83 L.Ed. 536, precludes such retroactive effect. It has been held, however, that the *Reynolds Tobacco* principle (that by repeated reenactment of a statute Congress gives its sanction to existing regulations) is applicable only when the regulations are legislative as opposed to "administrative" in character. *Automobile Club of Michigan v. Commissioner of Internal Revenue*, 20 T.C. 1033, 1041 (1953), *aff'd*, 230 F.2d 585, 589 (6th Cir. 1956), *aff'd*, 353 U.S. 180, 185-86, 77 S. Ct. 707, 1 L.Ed.2d 746, 751 (1957). See also *Helvering v. Reynolds*, 313 U.S. 428, 61 S.Ct. 971, 85 L.Ed. 1438 (1941), which confined *Reynolds Tobacco* to its facts, specifically the existence of a prior Regulation that negated a tax liability that the new and putatively retroactive regulation prescribed, and announced that Congressional reenactment of a statute that had been given a settled construction was no more than an aid in statutory interpretation and, where no regulations embodied the prior construction, did not preclude retroactively applying a regulation contrary to that construction.

Anderson, Clayton & Co. v. United States, 562 F.2d 972, 984-85 n.29 (1977). The court went on to consider the regulation cases in question. Like the advanced minimum mineral royalty regulation discussed *infra*, the substance of the rule had been extant for many years. See *id.* at 982-83. Thus, finalization of the regulation did no more, in the view of the Fifth Circuit, than to confirm an existing rule of long duration. "In sum, Treas. Reg. § 1.902-3(d)(1) (1975) did not alter a settled prior law or policy." *Id.* at 983 (footnote omitted). This view enabled the Fifth Circuit to sidestep the taxpayer's argument that the regulation was legislative (as opposed to merely interpretive) and that it should not, therefore, be granted retroactive effect. *Id.* at 984. The court focused instead on the general authority of the Secretary to issue regulations that merely confirm settled law. *Id.* at 984. The Fifth Circuit did not state that the result would be the same if the regulation were viewed as legislative. It did not mention the APA, nor did it conclude, as suggested by *Kaiser Cement Corp. v. United States*, 8 Cl. Ct. 34 (1985), that section 7805(b) overrides the APA. The court did state that "[n]either the courts nor Congress have drawn any distinctions between interpretive and legislative Treasury Regulations as regards their retroactivity," *Id.* at 984 (but cited only Rogovin, *The Four R's: Regulations, Rulings, Reliance, and Retroactivity - A View from Within*, 43 TAXES 756 (1976), as authority). Rogovin was Commissioner of the Internal Revenue Service at the time he authored the article and there is no evidence that his view reflects Congress' view. *Kaiser Cement* cites *Anderson, Clayton* for the proposition that the substantive/interpretive dichotomy is irrelevant to tax regulations. See also *Wilson v. United States*, 588 F.2d 1168, 1171 n.11 (6th Cir. 1978).

125. A mineral lease usually does not require the payment of "rent;" it requires the payment of a "royalty." A royalty is a payment for the right to extract or produce the mineral. It is calculated on a unit basis and lasts for the life of the lease.

126. Treas. Reg. § 1.612-3(b), T.D. 7523, 1978-1 C.B. 192, [hereinafter the Regulation].

(3) The payor, at his option, may treat the advanced royalties so paid or accrued in connection with mineral property as follows:

(i) As deductions from gross income for the year the advanced royalties are paid or accrued, or

(ii) As deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid, is sold.

On October 29, 1976, the date to which the amendment was retroactive, the regulation allowing the deduction had existed in the same form for more than fifteen years.¹²⁷ The predecessor regulation, virtually identical, Regulations 111, section 29.23M-10(C), issued pursuant to the 1939 Internal Revenue Code, had been in effect since 1940.¹²⁸ Thus, long-standing regulations permitted a taxpayer to claim a deduction in advance of receipt of income from his or her mineral interest.¹²⁹

The Service became concerned with the tax shelter uses to which this long-standing rule was put.¹³⁰ In barest outline, a mineral lease would require an investor to pay a large royalty in advance, attributable to some minimum amount of mineral to be extracted or produced in the future. When the mineral was extracted or produced, the investor would receive credit for his or her advance payment. The investor would receive no refund or credit if no mineral was extracted or produced or if the quantity extracted or produced fell short of the units that would produce the minimum advance payment. The investor was willing to make the payment, despite its nonrefundability, because he or she was able to deduct the payment in the year of payment and shelter other income from tax through the deduction.¹³¹

A notice of proposed rulemaking published October 29, 1976 in IRS Information Release No. 1687 and on November 2, 1976 in the Federal Register presaged a change in the regulations. The proposed amendment provided:

127. The Regulation was amended once in 1965; that amendment is irrelevant to the present discussion.

128. The history of Treas. Reg. § 1.612-3(b), T.D. 7523, 1978-1 C.B. 192, appears in Long v. United States, 10 Cl. Ct. 46 (1986). See *infra* notes 177-81.

129. The Service reaffirmed this treatment in Rev. Rul. 74-214, 1974-1 C.B. 148 and Rev. Rul. 70-20, 1970-1 C.B. 144. Rev. Rul. 70-20, 1970-1 C.B. 144, permitted deduction of advanced minimum royalties in the year paid or accrued. Rev. Rul. 74-214, 1974-1 C.B. 148, permitted deduction of lump sum payments, recoupable at specified rates in later years, in the year paid or accrued. News Release 1R-1687 (Oct. 29, 1976) announced the suspension of both revenue rulings. The news release did not suspend or revoke Treas. Reg. § 1.613-3(b), T.D. 7523, 1978-1 C.B. 192. Although the Service had become alarmed at the tax shelter potential created by these "up front deductions," the rulings reflected the ordinary accounting rules for cash and accrual basis taxpayers. Cash method taxpayers deduct an expense when it is paid; accrual basis taxpayers deduct an expense when all events have occurred that fix the liability and its amount is known with reasonable certainty.

130. See, e.g., King v. Comm'r, 50 T.C.M. (CCH) 387 (1985); Kaji v. Comm'r, 50 T.C.M. (CCH) 392 (1985); Chidnese v. Comm'r, 49 T.C.M. (CCH) 151 (1984); and Gibson v. Comm'r, 49 T.C.M. (CCH) 164 (1984).

131. Beginning in 1976, Congress curtailed sharply the ability of an investor to use deductions from tax shelter activities to shield unrelated income from tax through the enactment of section 465 of the Code. Prior to the enactment, a taxpayer could use nonrecourse leverage to create deductions far in excess of his or her out-of-pocket costs. Section 465, extended to almost all income-producing activities in 1978, limits deductions to the amount of income from the activity plus the amount by which a taxpayer is "at risk," the amount of his or her actual investment and the amount of any personal liability. The Tax Reform Act of 1986 has completed the demise of tax shelters.

§ 1.612-3 Depletion; treatment of bonus and advanced royalty.

.....

(b) *Advanced royalties.*

.....

(3) The payor shall treat the advanced royalties so paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. However, in the case of advanced royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the minimum royalty payments as deductions from gross income for the year in which the minimum royalties are paid or accrued. For purposes of this paragraph, a minimum royalty provision requires that substantially uniform royalty payments be made at least annually over the life of the lease.¹³²

On December 19, 1977, the Treasury issued the new regulation¹³³ and a new revenue ruling.¹³⁴ The new regulation provided:

(3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (*i.e.*, when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease The provisions of this subparagraph do not allow as deductions from gross income amounts disallowed as deductions under other provisions of the Code, such as section 461 (relating to general rule for taxable year of deduction), section 465 (relating to deductions limited to amount at risk in case of certain activities), or section 704(d) (relating to limitation on allowance to partners of partnership losses).

A careful reading of the new regulation suggests that deductions remained permissible in the year an advanced royalty was paid or accrued when substantially uniform royalties were to be paid at least annually over the life of the lease. Revenue Ruling 77-489,¹³⁵ issued the same day as the new regulation, illustrates the new rule in a case where a taxpayer voluntarily paid in advance the full ten years of cumulative minimum royalties that would otherwise have been due annually over the term of the mineral lease. The ruling concludes that the taxpayer was entitled to deduct in the

132. I.R. 1687, 41 Fed. Reg. 48133-34 (Nov. 2, 1976).

133. 42 Fed. Reg. 63640 (Dec. 19, 1977).

134. Rev. Rul. 77-489, 1977-2 C.B. 177. Revenue rulings escape the application of section 553(d) of the APA because they are "statements of general policy . . . or practice." Nevertheless, Treasury ordinarily follows a notice and hearing procedure for all rules, whether interpretive or legislative. Treas. Reg. § 601.201(a)(2)-(3) (1967).

135. 1977-2 C.B. 177.

year of payment only a portion of the advanced cumulative minimum royalty payment.¹³⁶

B. Wendland

The Tax Court decided the first in a series of cases,¹³⁷ *Wendland v. Commissioner*,¹³⁸ on August 23, 1982, in a "regular" opinion written by Judge Sterrett.¹³⁹ The petitioners were limited partners in a partnership formed December 30, 1976 (after the October 29th News Release, the November 2nd Federal Register notice, and the November 15th Internal Revenue Bulletin notice but before finalization of the amendment). The partnership, "TCR," acquired a coal mine through an agreement that obligated TCR to pay an advanced royalty of \$3 million in 1976. It paid the royalty by delivering \$650,000 in cash and a nonrecourse note for \$2,350,000. The Tax court did not believe TCR took this action in unknowing reliance upon the old regulation.¹⁴⁰ Rather, the court decided that the partnership acted despite its awareness of the proposed change.¹⁴¹ The court concluded, therefore, that the purpose underlying the notice requirement of section 553 was fulfilled.¹⁴² The court recognized the "apparent conflict" between the two statutes,¹⁴³ admitted that neither the statutes nor their legislative histories resolve the conflict, and concluded that the conflict was more apparent than real in the context of this case.¹⁴⁴ The court did this by accepting the view that literal application of section 553 was not required. Stating that literal compliance with section 553 would render section 7805(b) meaningless,¹⁴⁵ the court ignored the possibility of integrating the specific statutory rules of sections

136. Despite the imprecision of the proposed amendment, none of the plaintiffs in the cases discussed *infra* argued that the proposed amendment did not prohibit deduction of an advanced minimum royalty paid after issuance of the proposed amendment. That is, none of the plaintiffs argued that as a result of poor drafting Treasury had not done what it set out to do.

137. The cases decided by the Tax Court concerning this change in the regulations are included in the cases listed *infra* at note 157.

138. *Wendland v. Comm'r*, 79 T.C. 355 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir.), *aff'd sub nom. Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir.), *cert. denied*, 469 U.S. 1034 (1984).

139. 79 T.C. 355 (1982), *aff'd*, 739 F.2d 580 (11th Cir. 1984). *See infra* note 169.

140. The use by taxpayers of nonrecourse notes to increase the size of deductions was limited by the enactment of section 465 of the Code, Pub. L. No. 94-455, § 204, 90 Stat. 1531 (1976), applicable generally to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975. It did not apply, however, to coal leasing activities until two years later when section 465(c) was amended. Technical Corrections Act of 1979, Pub. L. No. 96-222, § 102, 94 Stat. 206 (1980). Attacks on "up-front" payments attributable to later periods accelerated as the pace of tax shelter sales increased. Beginning with deductions for multi-year interest payments, the Service succeeded in countering first with regulations (*e.g.*, anti-feed-lot regulation) and then with legislation, *e.g.*, section 263. The 1984 Deficit Reduction Act, Pub. L. No. 98-369, 98 Stat. 494 (1984), contains a broad provision requiring, in effect, accrual accounting by cash basis tax shelters for most expenses. *See* § 91(a) of the 1984 Act, adding section 461(h) of the Code.

141. The court notes that both the opinion of counsel and the tax "risk factors" sections of the offering memorandum contained discussions of the proposed change. *Wendland v. Comm'r*, 79 T.C. 355, 382 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir.), *aff'd sub nom. Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir.), *cert denied*, 469 U.S. 1034 (1984). Paragraph 4 of the "Risk Factors" section, reprinted in *Wendland*, *id.* at 370-71, warned investors of the proposed change and its possible negative impact on the partnership's deduction of the advanced royalty. In the tax opinion, reprinted in part in *Wendland*, *id.* at 374, counsel to the partnership stated the likelihood of challenge to the partnership's deduction should the amendment be retroactive.

142. *Id.* at 380.

143. *Id.* at 380-81.

144. *Id.* at 382.

145. *Id.* at 384.

553(d) and 7805(b). The Tax Court turned instead to its interpretation of the legislative history of section 553(d) alone.¹⁴⁶

The legislative history of the APA reveals that the purpose of the 30-day rule . . . was to afford affected persons a reasonable time to prepare for final effectiveness of a rule or to take any action which the issuance of the rule may require. . . . The notice requirements . . . provide an opportunity for interested persons to comment on proposed rules and for the agency promulgating the rule to educate itself before making the rule final.¹⁴⁷

Wendland involved several taxpayers (members of the same partnership) who appealed to both the Ninth and Eleventh Circuits.¹⁴⁸ The Ninth Circuit elaborated on the Tax Court:

It is doubtful that treasury regulations need to comply with the 30-day notice requirement. The specific statute giving the Secretary of the Treasury discretion to apply statutes retroactively (I.R.C. § 7805(b)) *would in any conflict take precedence* over the general notice statute (5 U.S.C. § 553(d)).¹⁴⁹

The Ninth Circuit thereby confirmed what was only suggested by the Tax Court. The Eleventh Circuit adopted the view of the Ninth.¹⁵⁰

The Tax Court claims that its view makes the letter of the Administrative Procedure Act inapplicable to tax regulations,¹⁵¹ while leaving intact its spirit. By accepting this view that literal compliance with section 553 of the APA is unnecessary, the court applied section 7805(b) of the Code in a way that renders meaningless section 553 of the APA. Furthermore, acceptance of the Commissioner's right to ignore the formal requirements of section 553 of the APA grants the Commissioner almost unfettered discretion to take retroactive regulatory action. Abandonment of the dichotomy between the APA and section 7805(b) requires adoption of the same standard for the permissibility of retroactive application for both substantive and interpretive tax regulations.¹⁵² As noted previously, taxpayers have

146. The court ignored the pre-existence of the predecessor of section 7805(b) of the Code, the existence of section 559 of the APA, and the limited reenactment of the Code since the APA was enacted in 1946.

147. *Wendland v. Comm'r*, 79 T.C. 355, 381 (1982) (citations omitted), *aff'd per curiam*, 739 F.2d 580 (11th Cir.), *aff'd sub nom.* *Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir.), *cert. denied*, 469 U.S. 1034 (1984).

148. *Wendland* went to the Eleventh Circuit where the decision was affirmed *per curiam*, 739 F.2d 580 (11th Cir. 1984); another plaintiff went to the Ninth Circuit where the case was affirmed *sub nom.* *Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir. 1984), *cert. denied*, 469 U.S. 1034 (1984).

149. *Redhouse v. Comm'r* 728 F.2d 1249, 1253 (9th Cir.) *cert denied*, 469 U.S. 1034 (1984). The Ninth Circuit cites *Wing v. Comm'r*, 81 T.C. 17 (1983) (*see infra* text accompanying notes 153–56) and *Bulova Watch Co. v. United States*, 365 U.S. 753 (1961). *Id.* at 1253. *Bulova Watch* is authority for the general maxim of statutory construction that the general rule bows to the specific, not for the proposition that the APA bows to the Code.

150. *Wendland v. Comm'r*, 739 F.2d 580, 582 (11th Cir. 1984).

151. It is at least arguable that even without the Tax Court's finding that the APA did not require formal notice, *Wendland* could have been decided adversely to the taxpayer because of the use of nonrecourse notes. In a number of these cases, the Tax Court ruled against the taxpayer by holding that delivery of nonrecourse notes did not constitute "payment," *e.g.*, *Surloff v. Comm'r*, 81 T.C. 210, 237–38 (1983).

152. *See, e.g.*, *King v. Comm'r*, 50 T.C.M. (CCH) 387 (1985); *Kaji v. Comm'r*, 50 T.C.M. (CCH) 392 (1985). Both cases state that all the taxpayer's arguments are answered by *Wing v. Comm'r*, 81 T.C. 17 (1983); *Surloff v. Comm'r*, 81 T.C. 210 (1983); *Elkins v. Comm'r*, 81 T.C. 699 (1983); and *Wendland v. Comm'r*, 79 T.C. 355 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir.), *aff'd sub nom.* *Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir.), *cert. denied*, 469 U.S. 1034 (1984). The arguments advanced by the taxpayers in these cases dealing with an arguably substantive regulation are the arguments applied to retroactive interpretive regulations.

had little success in challenging retroactive regulatory actions based on the abuse of discretion standard.

C. Wing

A second case dealing with Regulation section 1.612-3(b)(3) marks the second time the Tax Court considered the relationship between the Code and the APA. Following *Wendland*, Chief Judge Dawson rejected the petitioners' argument in *Wing v. Commissioner*¹⁵³ that retroactive application of the amended regulation was defective in at least five respects.¹⁵⁴ As in *Wendland*, the court concluded that technical compliance with section 553 was not necessary; as in *Wendland*, the court found that the taxpayers had ample opportunity to prepare for final publication of the regulation; as in *Wendland*, the court refused the opportunity to analyze fully the relationship between section 7805(b) and section 553.¹⁵⁵ Rather, in a footnote the court applied an old adage of legislative construction later repeated by the Ninth Circuit in *Wendland*. It said that when rules conflict, the one of more general application (the APA) gives way to the one of more specific application (the Code), thereby ignoring section 559 of the APA.¹⁵⁶ The second view, therefore, echoes the first: the Tax Court has eliminated the application of the Administrative Procedure Act to Treasury regulations.

D. Other Cases

In sixty-one other recent cases, a number of courts have considered the same alteration in the same regulation.¹⁵⁷ Fifty-four of these cases concerned coal

153. 81 T.C. 17 (1983).

154. The taxpayer in *Wing* argued that the amendment was invalid because (1) the Service did not comply with the APA, (2) the existing regulatory interpretation had acquired the force of law, (3) the existing regulatory interpretation could not be altered without congressional authorization because of the reenactment doctrine, (4) the choice of October 29, 1976, as the effective date constituted an abuse of discretion, and (5) the amendment violated the Service's own procedural rules. *Id.* at 24-25.

155. *Id.* at 28-30. The court also rejected as insignificant Treasury's failure to incorporate a basis and purpose statement in its announcement pursuant to 5 U.S.C. § 553(c) (1982), to consider submitted comments, and to allow a further comment period after publication of the final form on December 19, 1977. *Id.* at 30-32.

156. *Id.* at 33.

157. *Howe v. Comm'r*, No. 86-4142, slip op. (2d Cir. Mar. 17, 1987), *aff'g* 50 T.C.M. (CCH) 689 (1985); *United States v. Crooks*, 804 F.2d 1441 (9th Cir. 1986); *McCoy v. United States*, 802 F.2d 762 (4th Cir. 1986); *Brown v. Comm'r*, 799 F.2d 27 (2d Cir. 1986), *aff'g* 50 T.C.M. (CCH) 1418 (1985); *Ward v. Comm'r*, 784 F.2d 1424 (9th Cir. 1986), *aff'g* 48 T.C.M. (CCH) 1479 (1984); *Maddrix v. Comm'r*, 780 F.2d 946 (11th Cir. 1986), *aff'g* 83 T.C. 613 (1984); *Heinz v. Comm'r*, 770 F.2d 874 (9th Cir. 1985); *United States v. Flomenhoft*, 714 F.2d 708 (7th Cir. 1983), *cert. denied*, 465 U.S. 1068 (1984); *United States v. Osseman*, 82-1 U.S.T.C. (CCH) 83, 804 (D. Mass. 1982); *Aven v. United States*, 78-2 U.S.T.C. (CCH) 85, 450 (W.D. Okla. 1978); *Long v. United States*, 10 Cl. Ct. 46 (1986); *Deskins v. Comm'r*, 87 T.C. 19 (1986); *Abatti v. Comm'r*, 86 T.C. 1319 (1986); *Capek v. Comm'r*, 86 T.C. 14 (1986); *O'Neal v. Comm'r*, 84 T.C. 1235 (1985); *Vastola v. Comm'r*, 84 T.C. 969 (1985); *Seaman v. Comm'r*, 84 T.C. 564 (1985); *Ramsay v. Comm'r*, 83 T.C. 793 (1984); *Gauntt v. Comm'r*, 82 T.C. 96 (1984); *Elkins v. Comm'r*, 81 T.C. 669 (1983); *Surloff v. Comm'r*, 81 T.C. 210 (1983); *Engle v. Comm'r*, 76 T.C. 915 (1981), *rev'd*, 677 F.2d 594 (7th Cir. 1982). *aff'd*, 464 U.S. 206 (1984); *Davis v. Comm'r*, 74 T.C. 881 (1980), *aff'd*, 746 F.2d 357 (6th Cir. 1984); *Broutas v. Comm'r*, 73 T.C. 491 (1979), *vacated*, 692 F.2d 152 (1st Cir. 1982), *cert. denied*, 462 U.S. 1106 (1983); *Heitzman v. Comm'r*, No. 33436-84, T.C. Memo 1987-109, slip op. (Feb. 24, 1987); *Green v. Comm'r*, 52 T.C.M. (CCH) 1392 (1987); *Goldstone v. Comm'r*, 52 T.C.M. (CCH) 660 (1986); *Wasserstrom v. Comm'r*, 52 T.C.M. (CCH) 392 (1986); *Weinstein v. Comm'r*, 52 T.C.M. (CCH) 186 (1986); *Harmon v. Comm'r*, 51 T.C.M. (CCH) 1243 (1986); *Simon v. Comm'r*, 51 T.C.M. (CCH) 872 (1986); *Cheng v. Comm'r*, 51 T.C.M. (CCH) 861 (1986); *Fredkin v. Comm'r*, 51 T.C.M. (CCH) 865 (1986); *Miyagawa v. Comm'r*, 51 T.C.M. (CCH) 284 (1986); *Roth v. Comm'r*, 51 T.C.M. (CCH)

royalties.¹⁵⁸ Twelve of the remaining cases consider either section 7805(b) of the Code or the APA.¹⁵⁹ The Tax Court, the Claims Court, the District Court for Massachusetts, and two courts of appeals considered the application of either section 7805(b) of the Code or the APA to the same alteration in the same regulation. In seven cases, the court considered both the APA and section 7805(b) of the Code.¹⁶⁰ In none of the cases did the court recognize that the APA was becoming less and less relevant to tax regulation. In none did the court note the incentive for the inauguration of the predecessor of section 7805(b) of the Code and the exemption from section 553 of the APA for interpretive regulations. In none did the court acknowledge the existence of section 559 of the APA, outlawing implied exceptions to its domain.¹⁶¹ In most of the cases, the court sidestepped an examination of the APA/Code clash through concentration on the special facts of the case or a repetition of the reasoning

287 (1986); *Adelberg v. Comm'r*, 51 T.C.M. (CCH) 65 (1985); *Cohen v. Comm'r*, 51 T.C.M. (CCH) 46 (1985); *Lurkis v. Comm'r*, 51 T.C.M. (CCH) 15 (1985); *Lui v. Comm'r*, 50 T.C.M. (CCH) 536 (1985); *Nichols v. Comm'r*, 50 T.C.M. (CCH) 384 (1985); *Rosebrough v. Comm'r*, 50 T.C.M. (CCH) 386 (1985); *King v. Comm'r*, 50 T.C.M. (CCH) 387 (1985); *Kaji v. Comm'r*, 50 T.C.M. (CCH) 392 (1985); *Lund v. Comm'r*, 50 T.C.M. (CCH) 397 (1985); *Hershenhorn v. Comm'r*, 50 T.C.M. (CCH) 135 (1985); *Coffey v. Comm'r*, 49 T.C.M. (CCH) 910 (1985); *Gibson v. Comm'r*, 49 T.C.M. (CCH) 164, (1984); *Chidnese v. Comm'r*, 49 T.C.M. (CCH) 151 (1984); *Zegeer v. Comm'r*, 49 T.C.M. (CCH) 26 (1984); *Estate of Blay v. Comm'r*, 48 T.C.M. (CCH) 1463 (1984); *Tallal v. Comm'r*, 48 T.C.M. (CCH) 1082 (1984); *Burford v. Comm'r*, 48 T.C.M. (CCH) 1001 (1984); *Thompson v. Comm'r*, 48 T.C.M. (CCH) 412 (1984); *Walls v. Comm'r*, 46 T.C.M. (CCH) 1158 (1983).

158. *Howe v. Comm'r*, No. 86-4142, slip op. (2d Cir. Mar. 17, 1987), *aff'g* 50 T.C.M. (CCH) 689 (1985); *United States v. Crooks*, 804 F.2d 1441 (9th Cir. 1986); *McCoy v. United States*, 802 F.2d 762 (4th Cir. 1986); *Brown v. Comm'r*, 799 F.2d 27 (2d Cir. 1986); *Ward v. Comm'r*, 784 F.2d 1424 (9th Cir. 1986), *aff'g* 48 T.C.M. (CCH) 1479 (1984); *Maddrix v. Comm'r*, 780 F.2d 946 (11th Cir. 1986), *aff'g* 83 T.C. 613 (1984); *Heinz v. Comm'r*, 770 F.2d 874 (9th Cir. 1985); *United States v. Flomenhoft*, 714 F.2d 708 (7th Cir. 1983), *cert. denied*, 465 U.S. 1068 (1984); *United States v. Osserman*, 82-1 U.S.T.C. (CCH) 83, 804 (D. Mass. 1986); *Long v. United States*, 10 Cl. Ct. 46 (1986); *Deskins v. Comm'r*, 87 T.C. 305 (1986); *Abatti v. Comm'r*, 86 T.C. 1319 (1986); *Capek v. Comm'r*, 86 T.C. 14 (1986); *O'Neal v. Comm'r*, 84 T.C. 1235 (1985); *Vastola v. Comm'r*, 84 T.C. 969 (1985); *Seaman v. Comm'r*, 84 T.C. 564 (1985); *Ramsay v. Comm'r*, 83 T.C. 793 (1984); *Gauntt v. Comm'r*, 82 T.C. 96 (1984); *Elkins v. Comm'r*, 81 T.C. 669 (1983); *Surloff v. Comm'r*, 81 T.C. 210 (1983); *Davis v. Comm'r*, 74 T.C. 881 (1980), *aff'd*, 746 F.2d 357 (6th Cir. 1984); *Brontas v. Comm'r*, 73 T.C. 491 (1979), *vacated*, 692 F.2d 152 (1st Cir. 1982), *cert. denied*, 462 U.S. 1106 (1983); *Goldstone v. Comm'r*, 52 T.C.M. (CCH) 660 (1986); *Wasserstrom v. Comm'r*, 52 T.C.M. (CCH) 392 (1986); *Weinstein v. Comm'r*, 52 T.C.M. (CCH) 186 (1986); *Harmon v. Comm'r*, 51 T.C.M. (CCH) 1243 (1986); *Simon v. Comm'r*, 51 T.C.M. (CCH) 872 (1986); *Miyagawa v. Comm'r*, 51 T.C.M. (CCH) 284 (1986); *Roth v. Comm'r*, 51 T.C.M. (CCH) 287 (1986); *Adelberg v. Comm'r*, 51 T.C.M. (CCH) 65 (1985); *Cohen v. Comm'r*, 51 T.C.M. (CCH) 46 (1985); *Lurkis v. Comm'r*, 51 T.C.M. (CCH) 15 (1985); *Lui v. Comm'r*, 50 T.C.M. (CCH) 536 (1985); *Nichols v. Comm'r*, 50 T.C.M. (CCH) 384 (1985); *Rosebrough v. Comm'r*, 50 T.C.M. (CCH) 386 (1985); *King v. Comm'r*, 50 T.C.M. (CCH) 387 (1985); *Kaji v. Comm'r*, 50 T.C.M. (CCH) 392 (1985); *Lund v. Comm'r*, 50 T.C.M. (CCH) 397 (1985); *Hershenhorn v. Comm'r*, 50 T.C.M. (CCH) 135 (1985); *Coffey v. Comm'r*, 49 T.C.M. (CCH) 910 (1985); *Gibson v. Comm'r*, 49 T.C.M. (CCH) 164, (1984); *Chidnese v. Comm'r*, 49 T.C.M. (CCH) 151 (1984); *Zegeer v. Comm'r*, 49 T.C.M. (CCH) 26 (1984); *Estate of Blay v. Comm'r*, 48 T.C.M. (CCH) 1463 (1984); *Tallal v. Comm'r*, 48 T.C.M. (CCH) 1082 (1984); *Thompson v. Comm'r*, 48 T.C.M. (CCH) 412 (1984); *Walls v. Comm'r*, 46 T.C.M. (CCH) 1158 (1983).

159. In some of these, the court never reached the issue because the partnership was formed or began operations after final adoption in 1977. *See, e.g.*, *Coffey v. Comm'r*, 49 T.C.M. (CCH) 910 (1985).

160. *Ward v. Comm'r*, 784 F.2d 1424 (9th Cir. 1986); *Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir. 1984), *cert. denied*, 469 U.S. 1034 (1984); *Elkins v. Comm'r*, 81 T.C. 669 (1983); *Surloff v. Comm'r*, 81 T.C. 210 (1983); *Wing v. Comm'r*, 81 T.C. 17 (1983), 80 T.C. 537 (1983) (withdrawn 4/19/83); *Wendland v. Comm'r*, 79 T.C. 355 (1982), *aff'd per curiam*, 739 F.2d 580 (11th Cir.); *aff'd sub nom. Redhouse v. Comm'r*, 728 F.2d 1249 (9th Cir. 1984), *cert. denied*, 469 U.S. 1034 (1984); *Gibson v. Comm'r*, 79 T.C. 355 (1982); *Chidnese v. Comm'r*, 49 T.C.M. (CCH) 151 (1984).

161. 5 U.S.C. § 559 (1982).

of an earlier case.¹⁶² A sampling of some of these reveals the failure of the courts to reexamine the *Wendland* conclusion.

*Surloff v. Commissioner*¹⁶³ concerned the same amendment to the same regulation. The court found that the petitioners did not engage in the mineral transaction involved with a profit motive and were, therefore, not entitled to deductions;¹⁶⁴ the court did not consider the validity of the amendment date nor the interaction of APA section 553 and Code section 7805(b).

In *Gauntt v. Commissioner*,¹⁶⁵ the petitioners joined limited partnerships formed on October 28, 1976, one day before the Internal Revenue Service issued News Release IR-1687. The court found that "the 'obligations' of the partnerships prior to October 29, 1976, were illusory within the meaning of the news release, and the partnerships were not required, prior to October 29, 1976, to execute coal leases and pay the specified advance royalties."¹⁶⁶ After *Wendland* and *Wing* the court assumed its finding regarding the October, 1976 date was determinative.

In *Elkins v. Commissioner*,¹⁶⁷ there was no doubt that, as of the touchstone date, the partnership was bound; the issue was whether the petitioner was bound. The initial announcement, News Release IR-1687, said the amendment would not apply to royalties paid pursuant to a lease "binding prior to [the date of the News Release] on the party who in fact pays or accrues such royalties." The same language appeared in the Federal Register publication on November 2, 1976. The final version, appearing December 19, 1977, added a definition of "party" in the case of a partnership that required a taxpayer to be a partner before October 29, 1976. The Elkinses did not become partners until after that date. The court found the Service's interpretation inconsistent with the scheme of partnership taxation and the legal status of limited partners, and the Elkinses' interpretation of "party" more reasonable.¹⁶⁸ The court also found the retroactive addition of the definition of "party" an abuse of discretion but did not disagree with the retroactive application of the amended regulation as a whole (as approved by *Wendland* and *Wing*).¹⁶⁹

162. When a single judge wrote more than one opinion, he sometimes repeated the words from the first opinion in the second. See, e.g., Judge Dawson's opinions in *O'Neal v. Comm'r*, 84 T.C. 1235 (1985); *Gibson v. Comm'r*, 79 T.C. 355 (1982); *Chidnese v. Comm'r*, 49 T.C.M. (CCH) 151 (1984).

163. 81 T.C. 210 (1983).

164. *Id.* at 211.

165. 82 T.C. 96 (1984).

166. *Id.* at 104-05.

167. 81 T.C. 669 (1983).

168. *Id.* at 677.

169. *Id.* at 680. Because *Wendland* and *Wing* both appeared as regular decisions and neither was reviewed by the full court, it is fair to surmise that both represent the view of most, if not all, nineteen Tax Court judges. The Chief Judge decides whether an opinion should appear as a regular or a memorandum opinion. Tannenwald, Jr., "Tax Court Trials: A View from the Bench," 59 A.B.A.J. 295, 298 (1973), reprinted in M. GARBIS & S. STRUNZ, TAX PROCEDURE AND TAX FRAUD 285 (1982). Section 7462 of the Code requires publication of a regular opinion which then has precedential importance (Code § 7460(a)); a memorandum opinion does not appear officially and, in theory, has no precedential value. See M. TOWNSEND, "Tax Court Jurisdiction and Practice," Handling Federal Tax Litigation 37, 40 (1961); H. DUBROFF, THE UNITED STATES TAX COURT, AN HISTORICAL ANALYSIS 339 (1979). The trial judge transmits his draft opinion to the Chief Judge (Code § 7460(b)), who transmits copies to each of the other Tax Court judges (there are presently nineteen regular Tax Court judges). The Chief Judge may designate that the opinion will be published as a regular opinion or released as a memorandum decision. Unless objections are received from at least two judges (conversation February 21, 1985, with Judge Julian Jacobs), the Chief Judge's designation as regular or memo opinion and the draft become final. Upon receipt

Elkins was decided in favor of the taxpayer, not because there was an abuse of discretion in the retroactive date of applicability of the revised regulation, but rather, because the Service must advise taxpayers of the extent to which its retroactive power will be exercised.¹⁷⁰ At best, the opinion of the court in *Elkins* should be viewed as the importation of a gloss of "fairness" when an actual abuse of discretion in the Fifth Circuit sense is not present.

Many of the other cases that noted either the APA or section 7805(b) of the Code were also decided on the special facts that made the amendment clearly applicable.¹⁷¹ Nevertheless, in many of these, the court reiterated approvingly the conclusion of *Wendland* and *Wing*.¹⁷²

Although it appears that in several of the coal cases the taxpayer did not pay voluntarily but, rather, had a binding obligation under the terms of the mineral lease to pay in advance the cumulative minimum royalties due over a period of years,¹⁷³ none of the taxpayers argued that these facts distinguished his or her case from the ruling.¹⁷⁴ Nor is it clear whether, as in the Ruling, the full amount of all minimum royalties was paid in advance.

For these reasons, it is not possible to be certain of the parameters of the new regulation and ruling.¹⁷⁵ It is noteworthy, however, that the final regulation contained another basis for disallowing deduction of an advance payment: a reference to section 461.¹⁷⁶ Section 461 did not apply to prevent deduction in the year advance minimum royalties were paid or accrued under the revenue rulings and regulation in effect at the time of the transactions in the cases nor under the notice of proposed rulemaking. Only in its final form was the proposed regulation modified to provide that section 1.612-3(b)(3) does not allow as deductions amounts disallowed as deductions under other sections of the Code such as section 461.

of two or more objections, or on his own motion, the Chief Judge may direct a full court review. Conversation with Judge Jacobs; Tannenwald, Jr., *After Trial—How a Case is Decided*, 27 N.Y.U. Inst. on Fed. Tax'n 1505, 1512 (1968); see also Kern, *The Process of Decision in the United States Tax Court*, 8 N.Y.U. Inst. on Fed. Tax'n 1013, 1018 (1950).

170. *Elkins v. Comm'r*, 81 T.C. 669, 681 (1983).

171. See, e.g., *Ward v. Comm'r*, 784 F.2d 1424 (9th Cir. 1986), *aff'g* 48 T.C.M. (CCH) 1479 (1984) (nonrecourse note is not "payment"); *Gibson v. Comm'r*, 49 T.C.M. (CCH) 164 (1984) (no profit motive); *Chidnese v. Comm'r*, 49 T.C.M. (CCH) 151 (1984) (partnership formed nine days after final regulation).

172. See, e.g., *supra* note 162; *King v. Comm'r*, 50 T.C.M. (CCH) 387 (1985); *Kaji v. Comm'r*, 50 T.C.M. (CCH) 392 (1985).

173. E.g., *Wendland v. Comm'r*, 79 T.C. at 355 (1982); *Wing v. Comm'r*, 81 T.C. at 17 (1983); *Redhouse v. Comm'r*, 728 F.2d at 1249 (1984).

174. In *Wendland*, payments made by the investors totalled \$900,000. *Wendland v. Comm'r*, 79 T.C. 355, 358 (1982). The partnership used (at least part of) this amount to purchase a coal mine. *Redhouse v. Comm'r*, 728 F.2d 1249, 1250 (1984). The recital suggests that the full subscription was paid in cash. In *Wing*, however, the petitioner paid the subscription price with a check for \$10,000 and by delivery of an interest-bearing, nonrecourse promissory note. 81 T.C. 17, 20 (1983).

175. Perhaps another taxpayer could advance the arguments that the taxpayers in *Wendland*, *Wing*, and *Redhouse* overlooked. It is clear, however, that the Service would not wish to distinguish between taxpayers who pay the full amount of minimum royalties due from those who pay only a part. It is also clear that a requirement of accrual-type accounting for an expense by a cash method taxpayer should apply, if at all, to both voluntary and involuntary payments.

176. Section 461(a) of the Code provides:

(a) GENERAL RULE—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

I.R.C. § 461(a) (1986). Section 461 is a powerful tool in the hands of the Service. It permits the Service to require a taxpayer to use a different method of accounting for all items or for only a single item to prevent distortion.

*Long v. United States*¹⁷⁷ is one of the coal cases that considers section 7805(b) of the Code and the APA. It also considers the reference to section 461.¹⁷⁸ It is the first case to consider whether a taxpayer, who paid or accrued a liability with respect to a minimum royalty that exceeded an amount attributable to an annual period, could deduct the payment or accrual in its entirety.¹⁷⁹ The court held that the Commissioner had abused his discretion by failing to give notice that a change was going to be made that would prevent a deduction.¹⁸⁰ That is, the Court of Claims found in *Long* that the belated reference to section 461 constituted an abuse of discretion.¹⁸¹

Treasury Regulation section 1.461-1(a)(1) sums up the Service's real focus in amending the regulation: the mismatching of income and expense producing an ordinary deduction now and income (perhaps at capital gains rates) later.¹⁸² Thus,

177. 10 Cl. Ct. 46, 86-1 U.S.T.C. (CCH) 83,931 (1986).

178. 10 Cl. Ct. 46, 57, 86-1 U.S.T.C. 83,931, 83,938-39 (1986).

179. In *Long*, the court stated:

From 1940 to adoption of the final amendment, the regulations relating to the tax treatment of advanced minimum royalties contained no reference to these general rules. The plain meaning of the regulation before final amendment was that a taxpayer who paid a minimum royalty or accrued a liability with respect thereto that exceeded an amount attributable to an annual period nevertheless could deduct from gross income such payment or accrued liability in its entirety. This interpretation is reinforced by the addition of language in the regulation as adopted in 1977 that effectively eliminates the term "accrued." Although liability for annual payments may be accrued in year one, the added language requires deduction of the annual payments in the year to which they are attributable. This has the effect of requiring the deductions to correspond to the payments that must be made annually and thereby eliminates the option to deduct the liability when accrued. The tortured language of the regulation as adopted thus gives the taxpayer an option to deduct advanced minimum royalty payments from gross income for the year in which the liability for the royalties is accrued unless the taxpayer makes annual payments, as he must to qualify for advanced minimum royalty treatment in the first place. Obviously, the meaning of the 1960 and proposed regulations was changed in the regulation as adopted.

10 Cl. Ct. 46, 56; 86-1 U.S.T.C. 83,931, 83,938 (1986).

180. The court in *Long* continued:

The plain meaning of the language of Treas. Reg. § 1.612-3(b)(3) as it existed in the 1960 and proposed regulations on August 1, 1977, authorized the deduction in 1977. Because neither the suspension of Rev. Ruls. 70-20 and 74-214 nor the proposed regulation published on November 2, 1976, gave notice that a change was going to be made affecting the option to deduct advanced minimum royalties when paid or accrued, the partnership would sustain "inordinate harm" if it were forced to comply with the final amendment to Treas. Reg. § 1.612-3(b)(3), as adopted on December 14, 1977, or the interpretation of the regulation under Rev. Rul. 77-489. It is concluded, therefore, that the Secretary abused his discretion by failing to provide the partnership "adequate guidance as to the extent to which his power . . . [would] be exercised, or at the very least to avoid misleading them." *Elkins v. Commissioner* [CCH Dec. 40,514], 81 T.C. 669, 681 (1983) (abuse of discretion regarding change in the effective date of provisions of Treas. Reg. § 1.612-3(b)(3) after announcement in the News Release and Federal Register).

10 Cl. Ct. 46, 59; 86-1 U.S.T.C. 83,931, 83,940 (1986). But the plaintiffs in *Long* had deliberately negotiated their sublease in reliance on the proposed regulation. The sublease, therefore, did not require substantially uniform payments over the life of the lease. As a result, the court's finding of an abuse of discretion did not benefit them. 10 Cl. Ct. 46, 63; 86-1 U.S.T.C. 83,931, 83,943 (1986). The court did not, however, refer to the formal requirements of the APA. Rather, it applied the standard for a retroactive interpretive regulation (abuse of discretion), not the standard for a retroactive substantive regulation.

181. The reference is not enough, however, because section 461(a) merely requires that a deduction be taken for the proper year under the taxpayer's method of accounting. Since a cash method taxpayer may deduct expenses when payments are actually made and an accrual method taxpayer may deduct expenses when the obligations become fixed and the amounts determinable, the reference is not to the general rule but to a regulation issued under section 461 pursuant to the authority of section 7805(a) of the Code, Treas. Reg. § 1.461-1(a)(1) T.D. 6917, 67-1 C.B. 108. That section of the regulations provides that if an expenditure results in the creation of an asset having a useful life that extends substantially beyond the close of the tax year, the expenditure may not be deductible or may be deductible only in part for the tax year in which made.

182. After the Tax Reform Act of 1986, transmutation of ordinary income into capital gain income has become mostly a thing of the past. The Code no longer contains a preferential rate of tax on capital gains income, but capital gains and losses are still segregated. Capital losses can now offset ordinary income to a maximum of \$3,000 per year.

when after a long delay the Treasury issued the final regulation, its real concern was revealed only obliquely through a procedure that did not satisfy the requirements of the APA. The amendment of this one regulation illustrates the imprecision courts lavish on issues of retroactivity in the tax area.¹⁸³ As a result, what could have been *Anderson, Clayton's* legacy has been overlooked by several courts in favor of an abandonment of any role for the APA in Treasury regulation of tax matters.

Why then do the courts seem so willing to rescue the Treasury from its own failures?¹⁸⁴ In 1941, Erwin N. Griswold summarized the problem of the effect that should be given to Treasury regulations in the construction and application of the Federal Revenue Acts.¹⁸⁵ He began by noting that the previous articles had illustrated both the great uncertainty of the area and the fact that the rather large number of cases afforded a means for reaching virtually any desired destination.¹⁸⁶ More than 40 years have not illuminated the forest he sought to see better by focusing on fewer trees.¹⁸⁷

VI. RETROACTIVITY AND THE REGULATORY PROCESS

Since there is little constitutional control of retroactive tax legislation or regulation,¹⁸⁸ if there are no legislative or judicial limits, a regulation may be retroactive to at least four and sometimes six different events:

- (1) the date of adoption;
- (2) the date the statute to which it relates became effective;
- (3) the date of an earlier interpretation, if any;
- (4) the date of announcement of a proposed change in interpretation;

183. The Tax Court focused on the wrong date in both *Wendland* and *Wing*. Both judges concluded there was no significant change from the proposed amendment published in the Federal Register on November 2, 1976 to the final version published in the Federal Register on December 19, 1977. Both cases, however, dealt with the earlier announcement date of October 29, 1976, when no text appeared upon which a taxpayer could base decisions. See *Wendland v. Comm'r*, 79 T.C. 355, 379 (1982); *Redhouse v. Comm'r*, 728 F.2d 1249, 1250 (1984); *Wing v. Comm'r*, 81 T.C. at 30 n.17 (quoting *Bulova Watch Co. v. United States*, 365 U.S. 753, 758 (1961)) (the specific controls the general without regard to priority of enactment). But see text at notes 147-56. In *Redhouse*, 728 F.2d 1249, 1253 (1984), the court said that although regulations issued under the authority of section 611(a) are "arguably legislative in character," this amendment to those regulations was issued in order to revoke an erroneous interpretation of the earlier regulation. The erroneous interpretation was based upon two revenue rulings that gave a broad construction to an ambiguity in the regulation. Revenue rulings merely represent the opinion of the Commissioner and are therefore classic examples of interpretive rules. *Wing v. Comm'r*, 81 T.C. 17, 27 (1983). The amendment, changing the Commissioner's revenue rulings, was also of an interpretive nature. *Redhouse v. Comm'r*, 728 F.2d 1249, 1253 (1984).

184. The legislative history of the relevant provision of the APA, section 553(d), suggests that no conflict exists with section 7805(b). While the Code provision reverses the effect of the declaratory theory of interpretive regulations, section 553 of the APA provides affected persons with a transition period to prepare for final effectiveness of a new or revised substantive rule. Therefore, the Tax Court did not need to find in *Wendland* that the purpose of section 553 had been fulfilled or in *Wing* that the general APA should give way to the more specific Code. Since the Tax Court did, however, improperly analyze the interaction of the APA and the Code, the APA will be without application to tax regulations until the issue arises once again. The only appellate decisions concerning the interaction of section 553 of the APA and section 7805(b) of the Code are the Ninth and Eleventh Circuit decisions in the appeals of *Ward*, 784 F.2d 1424 (9th Cir. 1986); *Wendland*, 739 F.2d 580 (11th Cir. 1984); and *Redhouse*, 728 F.2d 1249 (9th Cir. 1984). See *infra* note 223.

185. Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398 (1941) [hereinafter Griswold].

186. *Id.* at 398.

187. *Id.*

188. See *supra* notes 30-32.

(5) the date of publication of the proposed change;¹⁸⁹ or

(6) the date to which the statute of limitations is open for the amendment of a tax return.¹⁹⁰

Each of these may be appropriate in some circumstances; none will be appropriate in all. In part, the most appropriate will depend on the nature of the taxpayer action affected by the regulation. Yet courts considering retroactivity repeatedly ignore the complexity of change. Their opinions reflect an inability or unwillingness to recognize the choices available. Not surprisingly, Treasury too has foregone its opportunities to create a method for evaluation based on recognition that the choice is not simply "retroactivity" or "prospectivity."

A. Possible Solutions

In his landmark article on retroactivity of income tax laws,¹⁹¹ Professor Michael J. Graetz notes that most discussions focus on "nominal retroactivity," effective date provisions that apply new rules to transactions that occurred before enactment. A new or amended regulation is nominally retroactive with respect to those transactions to which it applies that occurred prior to publication and that cannot be changed after publication.¹⁹² If the taxpayer has the power after publication to alter a transaction that occurred prior to publication, the regulation is not "nominally retroactive." A new or amended regulation designated to apply only prospectively may also be retroactive in effect, however. Professor Graetz designates these changes as "nominally prospective." The effect of these nominally prospective changes is generally on the value of assets acquired prior to the first notice of change. These designations are useful for analyzing changes in regulations.

A "nominally prospective" change may affect transactions that occurred prior to publication. A nominally prospective change may, for example, affect the value of an asset. Because a taxpayer's permissible use of the asset is changed by the new regulation, its value may be depressed (or increased) by the effect of the regulation. For example, a regulation sharply limiting coal with a high sulphur count will decrease the royalty-generating potential of one mineral interest while increasing that of another. A nominally prospective regulation may also affect the value of an income stream. Rental payments based on a percentage of net income may decline sharply after a new regulation introduces a new required expense for the net-lease tenant.¹⁹³

189. An announcement of proposed rulemaking will, in most cases, constitute constructive notice to all interested taxpayers and, therefore, is the equivalent of publication of a draft rule. As was noted by the New York State Bar Association, the real effect of notice is to create a period during which no governing law exists. *Report of the Committee on Tax Policy, supra*, note 31, at 24. Although this might not be the case for those taxpayers who are unaware of the need for guidance or unable to hire tax lawyers, for others, the effect—an uncertain change in the law—is the same following an announcement like that made on October 29, 1976 regarding Treas. Reg. § 1.612-3(b) or publication of a full-fledged draft. Both create a period of suspension of law.

190. The general rule permits amendment up to three years from the later of the due date for the return or the date the return is actually filed. A variety of special exceptions may extend the period.

191. Graetz, *supra* note 71.

192. *Id.* at 49.

193. *Id.* at 49-59. The value decreases if the asset is less useful and increases if the owner can make additional uses

Despite Treasury's admitted recognition of these problems of retroactivity,¹⁹⁴ however, those within Treasury who make the decisions do not have time and may not have the expertise to conduct a precise analysis.¹⁹⁵ To paraphrase Davis, the problem is not whether to make changes retroactive but to distinguish the nature of the retroactive effect and choose the applicable date of effect accordingly.¹⁹⁶

In *Helvering v. R. J. Reynolds Tobacco Co.*¹⁹⁷ the Supreme Court said that a regulation that has continued in effect during a reenactment of the statute that it construes becomes itself a part of the law and is just as binding upon all concerned

of it. The effect of a change depends heavily, however, on the nature of the activity and the effective date of the change. Because entry into a mineral lease takes place at a specific point in time, the investor whose lease preceded the amendment to Treas. Reg. § 1.612-3 was unaffected by the change since application depended on the date of the lease, not the ongoing payment stream. As a result, the value of the lease to the investor was unchanged while the value of the interest of the owner of the underlying mineral interest declined. When the present lease ends, the change in the regulation will make the rental value lower, making the interest less valuable than before the change. Application to all payments after the promulgation date would produce a different impact, lowering the value of the investment immediately for both the lessor and the owner of the underlying interest. To measure these changes requires a sophisticated analysis of the impact of change on expected cash flow and values. It also requires projections of economic factors, *e.g.*, interest rates, inflation, and a choice of tax rates and exemptions. See Graetz, *id.* at 50. In Professor Graetz's follow-up article, he notes:

Because all changes in law, whether nominally retroactive or nominally prospective, will have an economic impact on the value of existing assets or on existing expectations, the distinctions commonly drawn between retroactive and prospective effective dates are illusory. Skills are developed, locations selected, and employment accepted or terminated based upon people's expectations about the future burdens and rewards of such decisions. Likewise, the economic value of a physical asset reflects people's expectations about the asset's earning prospects. Therefore, purportedly prospective changes in the law that alter people's expectations about their earning prospects or their potential savings or consumption, or, as is very often the case, alter the value of an asset (or liability, as Shachar points out) have retroactive effects. Understood in this way, all changes in tax law—indeed, I think, all changes in economic laws—are inherently retroactive. A major contribution of my earlier work was to demonstrate the essential similarity in economic impact between a change in law that is nominally retroactive and a change that is nominally prospective but that also has an effect on the value of past transactions. Whenever a change in law alters the relative value of an asset (or liability) or an individual's expectations about her earning prospects or her ability to consume or save from accumulated wealth, it can properly be classified as retroactive. Consequently, one should evaluate all possible types of effective dates without concern for the pejorative label "retroactive" or the misleading and undoubtedly hypothetical designation "prospective." (Footnotes omitted).

Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1822 (1985).

194. See U.S. Dept. of the Treasury, *Blueprint for Basic Tax Reform* 181 (1977).

195. Treasury's Office of Economic Analysis would have to develop a model in consultation with other tax and economic experts. The Office of Economic Analysis may have the capability to devise proper econometric models but the current budget austerity makes early implementation unlikely.

196. Davis states:

The problem was not whether to make law retroactively but what law to make retroactively; opposition to retroactive lawmaking could not contribute to the solution. The ultimate truth may be that a legal system without retroactive lawmaking may be impossible; the whole of the common law is the product of retroactive lawmaking.

2 DAVIS TREATISE, *supra* note 1, § 7:23 at 111.

Scarce any man has the means of knowing a twentieth part of the laws he is bound by. Both sorts of law are kept most happily and carefully from the knowledge of the people: statute law by its shape and bulk; common law by its very essence. It is the judges (as we have seen) that make the common law. Do you know how they make it? Just as a man makes laws for his dog. When your dog does anything you want to break him of, you wait till he does it, and then beat him for it. This is the way you make laws for your dog; and this is the way the judges make law for you and me. They won't tell a man beforehand what it is he should not do—they won't so much as allow of his being told: they lie by till he has done something which they say he should not have done, and then they hang him for it. What way, then, has any man of coming at this dog-law? Only by watching their proceedings: by observing in what cases they have hanged a man, in what cases they have sent him to jail, in what cases they have seized his goods, and so forth.

5 BENTHAM, WORKS 235, (1843).

197. 306 U.S. 110 (1939).

(including the courts) as is the statute itself.¹⁹⁸ There is no constitutional, legislative, or common law prohibition, however, that prevents a retroactive change to such a "binding" regulation by the Service if the regulation is merely interpretive.

The courts have not fashioned a clear demarcation between substantive and interpretive, however. The problem with basing treatment on this illusory identification is graphically illustrated by *Eastern Kentucky Welfare Rights Organization v. Simon*.¹⁹⁹ The case concerned a 1979 amendment made by Treasury to long-standing requirements for "charitable" hospitals when Revenue Ruling 69-545²⁰⁰ replaced Revenue Ruling 56-185. The earlier Revenue Ruling had held that a hospital could qualify for tax exemption only if it was "operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay."²⁰¹ The new ruling modified this position by broadly defining "charitable" in terms of the community benefit. The replacement ruling held that the promotion of health constitutes a "charitable purpose" in the generally accepted sense of the term and within the meaning of section 501(c)(3) of the Code.²⁰² Based upon this newer definition, a non-profit hospital could qualify as a charitable organization under section 501(c)(3) and, therefore, be tax exempt and eligible to receive tax deductible contributions "by operating an emergency room open to all persons and by providing hospital care for all those persons in the community able to pay the cost thereof either directly or through third party reimbursement"²⁰³

A group of poor patients challenged the ruling, claiming that as a result of the ruling a hospital could qualify as tax exempt although it no longer provided free or below-cost service to those unable to pay. The group included health and welfare organizations and indigent persons. Among other contentions, the plaintiffs argued that the Treasury had failed to fulfill its obligation under the APA to afford them an opportunity to be heard. They argued that the replacement ruling, Revenue Ruling 69-545, was a substantive rule (as opposed to an interpretive rule) and that, therefore, section 553 of the APA required notice and public comment. Despite a well-reasoned dissent, the majority held that the revenue ruling represented a mere interpretation of the term "charitable" in section 501(c)(3) of the Code.²⁰⁴

198. *Id.* at 115-16.

199. 506 F.2d 1278 (D.C. Cir. 1974), *rev'd on other grounds*, 426 U.S. 26 (1976).

200. Rev. Rul. 69-545, 1969-2 C.B. 117.

201. *Id.* at 117.

202. *Id.*

203. *Id.* at 118.

204. Most startling, however, was the statement of the majority that:

[A]pellants concede that Revenue Ruling 69-545 has no independent binding effect and that the courts are not bound by it unless they choose to accept it as a proper interpretation of the meaning of the word "charitable" as used in § 501(c)(3). We conclude that Revenue Ruling 69-545 is an interpretive ruling and is not subject to the requirements of § 553 of the APA.

Eastern Ky. Welfare Rights Org. v. Simon, 506 F.2d 1278, 1290 (1974) (citations omitted). Judge Skelly Wright disagreed. He agreed with the plaintiffs that Rev. Rul. 69-545 worked a substantial change in the availability of hospital services to the poor and believed that the change should have been subject to the APA. The plaintiffs then moved to have their case reheard *en banc* but were refused. Chief Judge Bazelon issued a statement as to why he voted to grant a rehearing *en banc*. In it he wrote as follows:

The panel opinion concedes, as it must, that rulemaking procedures are required if Rev. Rul. 69-545 has an

While one might view this case as merely a symptom of the lack of a uniform standard for determining when a regulation is interpretive rather than substantive, it is also important because it illustrates both the binding effect on courts of administrative rulings and the fact that some rulings, at least arguably substantive in nature, may, in fact, be unchallengeable.

To make the appropriate choice requires an agency, the Service, to exercise its discretion in a more sophisticated manner than has been its past practice. Until the courts or Congress require it to do so, it is unlikely that the Service will undertake the type of analysis necessary to measure the impact of the alternative choices. Because the analysis is complex, may vary depending upon what is being regulated, and there are no quantitative models available at present, recognition that even nominally prospective changes may have retroactive effects suggests at least that the Service should adhere to formal standards.

Therefore, it is not surprising that many authors have suggested that there should be legislatively mandated or self-imposed limits on the Service's power to promulgate changes retroactively through issuance, amendment, or revocation of regulations or rulings. These articles are indicative of the dissatisfaction of courts and taxpayers with present practices. This dissatisfaction argues for a reexamination of the choices available to rationalize administrative regulations in the tax area. The Service could:

- (1) utilize advanced quantitative analyses;
- (2) ignore the APA and continue on the present course;
- (3) identify legislative and interpretive regulations and apply the APA to those viewed as legislative and section 7805(b) to those viewed as interpretive; or
- (4) permit retroactive promulgation or amendment only in the formative period after enactment or amendment of a Code provision and require application of the APA to all other new or amended regulations unless the Service can demonstrate an absence of the *Anderson*, *Clayton* factors.

Of these, perhaps the most desirable would be adoption by the Service of sophisticated analyses. Any econometric model would probably not produce uniform acceptance by the commentators,²⁰⁵ however.

"independent binding effect." If the Rev. Rul. were no more than "an opinion of the legal staff" of the Treasury, I might agree with the majority that courts "are not bound by [the Revenue Ruling] unless they choose to accept it" and that, therefore, the Rev. Rul. has no independent binding effect. But in light of the traditional deference to Internal Revenue Service regulations in the interpretation of the more general sections of the Internal Revenue Code of 1954, I think it a truly heroic assumption that courts will not be bound by the Ruling "unless they choose to accept it." Indeed, this tradition of deference informs the panel majority's own approach to the legality of Rev. Rul. 69-545. The majority does not review the issue *de novo* but instead concludes that the Ruling "is founded on a permissible definition of the term further 'charitable' and is not contrary to any express Congressional intent." If the majority were to review the issue *de novo*, it would, I take it, certainly want more information than is contained in the record before us here. And it is for expressly that reason, as Judge Wright so persuasively argues, that rulemaking hearings are required. So the majority tells plaintiffs that it will not be bound by Internal Revenue Service interpretation of the term "charitable" and then turns right around and upholds the Service interpretation as a permissible exercise of discretion on the basis of factual assumptions which are not supported by a record and which plaintiffs have not had an opportunity to rebut. I will not concur in such reasoning.

Id. at 1292-93.

205. Graetz, *supra* note 71, remains the outstanding article concerning transition dates for tax legislation. Among

In the alternative, the Service could continue its present course and wait for congressional instruction to resurrect the APA. But until then, no taxpayer could be certain that a regulatory change will not occur retroactively.

The Service could adopt a policy of strict adherence to the APA coupled with the recognition that almost no regulatory change can, logically, come within the declaratory rule.²⁰⁶ Professor Saunders suggests in a recent article that the regulatory agency should have to choose whether a regulation will have legislative effect or not.²⁰⁷ Pursuing his model, if the agency chose legislative effect when issuing a regulation, it would have to comply with the APA and be judged by the standards appropriate to a substantive regulation. The regulation would then have the force of law. If the agency chose interpretive effect, the standards of section 7805(b) of the Code would apply and the regulation's efficacy would be judged using the abuse of discretion yardstick. But based upon the difficulty of identifying which Treasury regulation is substantive, which interpretive, this does not appear to be a workable alternative.

More than forty-five years ago, Professor Griswold, anticipating by more than five years the APA, suggested an alternative not unlike the fourth choice noted here. He suggested "allowing administrative freedom [only] in the early days of the statute and denying it after the administrative action has taken form and shape and become definite."²⁰⁸ His idea is the more appealing because it is similar to what Treasury has been doing *de facto* until now,²⁰⁹ and it has been (in part) blessed by the Supreme Court.²¹⁰ Furthermore, his prescription may be used as the touchstone for determining application of the APA in the tax regulation field. In the period immediately following enactment or amendment of a statute, the Service should have unfettered license to issue regulations and to choose retroactivity or prospectivity to one of the dates enumerated earlier. With the passage of time, however, the agency's freedom should shrink. As soon as a pattern of practice becomes identifiable, the APA should apply to all new or amended regulations unless Treasury can demonstrate that the change will have no harsh results, cause no discrimination, and be detrimental to no reliance interest.

While this choice might lead to windfalls to some taxpayers, its benefits outweigh the cost. Taxpayers would know that a regulation can be relied upon while Treasury would know that the regulation would be applied to transactions carried out

commentators, however, there is disagreement concerning some aspects of Professor Graetz's model. Compare Graetz, *supra* note 71; Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1822 (1985); and Abrams, *Rethinking Tax Transitions: A Reply to Dr. Schachar*, 98 HARV. L. REV. 1809 (1985); with Schachar, *The Importance of Considering Liabilities in Tax Transitions*, 98 HARV. L. REV. 1842 (1985); and Schachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 HARV. L. REV. 1581 (1984).

206. See *supra* text accompanying notes 43-55.

207. Saunders, *Interpretive Rules With Legislative Effect: An Analysis and a Proposal for Public Participation*, 1986 DUKE L.J. 346 (1986).

208. Griswold, *supra* note 185, at 410-11, 414.

209. See *supra* note 134. Application of the notice requirement of the APA to most regulatory actions is currently a matter of administrative grace and not subject to clear standards.

210. *Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920); *United States v. Morehead*, 243 U.S. 607 (1917); *United States v. Birdsall*, 233 U.S. 223; *United States v. Grimaud*, 220 U.S. 506 (1911).

while the regulation stands,²¹¹ and the courts would have only to determine as a factual matter when a transaction took place.

B. Analogies to Other Agencies

Although the Administrative Procedure Act had not been addressed in the context of regulations issued by the Service prior to *Anderson, Clayton* and the advanced mineral royalty cases,²¹² a number of cases have considered regulations issued by other federal agencies. These cases illustrate a strong policy disfavoring retroactivity, particularly where an established rule has been in effect for a long period and has been relied upon by persons who will be subject to the new rule.²¹³ This is especially true when the ill-effects of a retroactive application of the new policy outweigh the need for immediate application or the hardship outweighs any public end.²¹⁴

In the tax area, however, identification of the possible effective dates is merely a first step. Even if there were agreement as to the extent of harm warranting non-retroactivity,²¹⁵ it is unlikely that a workable framework can be promulgated. Without a framework or checklist, uniform economic standards seem beyond the ability of the Service. In that case, the Service owes a duty to taxpayers, at a minimum, to apply the APA procedure to all regulatory actions that have substantive impact and change existing practice. A notice and comment period would also provide at least an administrative opportunity for taxpayers to oppose a rule that might be otherwise unreviewable.²¹⁶

In general, the APA requires that a substantive rule be promulgated in harmony with its procedural requirements.²¹⁷ A regulation not promulgated with a thirty-day delay will not be enforced, at least not until the thirty days from the date of publication elapses.²¹⁸ The public policy underlying the notice requirement is so strong that it has been held that a retroactive change is not permitted if the rule arises from inter-agency activity that is not subject to input from the outside.²¹⁹ Section 553 permits the promulgation of a regulation without the thirty-day notice delay if there is "good cause" for immediate applicability. Most regulations do not enjoy that dispensation. The legislative history and cases clearly demonstrate this to be the rare

211. *Griswold*, *supra* note 185, at 414.

212. *See supra* notes 29 and 134.

213. *E.g.*, *Shell Oil v. Kleppe*, 426 F. Supp. 894 (D. Colo. 1977), *aff'd*, 591 F.2d 597 (10th Cir. 1979), *aff'd*, 446 U.S. 657 (1980).

214. *E.g.*, *Iowa Power & Light Co. v. Burlington N., Inc.*, 647 F.2d 796 (8th Cir. 1981), *cert. denied*, 466 U.S. 949 (1984); *Tenn. Gas Pipeline Co. v. Federal Energy Regulatory Comm'n*, 606 F.2d 1094 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980).

215. *See supra* notes 102 & 105.

216. The requirement of standing enunciated in *Flast v. Cohen*, 392 U.S. 83 (1968) and illustrated in *Eastern Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278 (D.C. Cir. 1974), *rev'd on other grounds*, 426 U.S. 26 (1976), may make many tax regulatory actions unreviewable. *See* § 28 *DAVIS TEXT*, *supra* note 3; *Allen v. Wright*, 468 U.S. 737 (1984); *Warth v. Seldin*, 422 U.S. 490 (1975).

217. *Haddon Township Bd. of Educ. v. New Jersey Dept. of Educ.*, 476 F. Supp. 681 (D.N.J. 1979).

218. *Rowell v. Andrus*, 631 F.2d 699 (10th Cir. 1980).

219. *Montana Power Co. v. EPA*, 429 F. Supp. 683 (D. Mont. 1977), *rev'd*, 608 F.2d 334 (9th Cir. 1979) (retroactive change is impermissible if intra-agency action is not subject to input from outside). *But see* *Eastern Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278 (D.C. Cir. 1974), *rev'd on other grounds*, 426 U.S. 26 (1976).

exception. Even the limited nature of a rule cannot justify the agency's failure to follow the notice and comment requirements regarding a substantive rule.²²⁰

There are at least two reasons for the extraordinary weight the policy of conformity with the Administrative Procedure Act enjoys. Of perhaps greatest significance is the fact that rules or regulations issued by an administrative agency apply broadly.²²¹ They affect many individuals and entities who may be dissimilarly situated. As a consequence, the new or amended rule or regulation will have different effects on different individuals or entities. This is in sharp contrast to the decision of a court that, at most, will apply to all those similarly situated; it may, in fact, apply only to the litigant before the court. Of perhaps lesser, although certainly great, significance is the lack of direct accountability of administrators. Although politicians are accountable to both the political process and the courts when they enact new or amended legislation and decide whether the new or amended legislation should apply retroactively, administrators are accountable only to the courts and may feel a greater responsibility to the fisc than to citizens. Furthermore, as previously noted, much agency action is never reviewed or may be nonreviewable.²²²

The Tax Court, the Claims Court, and the Ninth Circuit did not, however, illuminate the murk when they recently had the opportunity. Rather than charting a new course, the respective judges, like others before, relied upon a maxim and a mislabelling of a substantive regulation. Their failure could adversely affect tax planning for many more years. After these cases, a taxpayer must assume that any regulation may be issued and amended retroactively, no matter how legislative in character. This need not have been the outcome.

While the Code provision reverses the effect of the declaratory theory of interpretive regulations, section 553 of the APA provides a delay in the implementation of substantive rules so that affected persons may have a transition period to prepare for final effectiveness of a new or revised substantive rule. These are not contradictory rules. Nor does the legislative history of either section 553 of the APA²²³ or section 7805(b) of the Code suggest a conflict between the two or superiority for one over the other.²²⁴ The Tax Court did not need to ignore the specific statutory language to find in *Wendland* that the purpose of section 553 had been fulfilled nor to find in *Wing* that the general statute, the APA, should give way to the more specific statute, the Code. Since the Tax Court did, however, improperly analyze the interaction of the APA and the Code, the APA may be without application to tax regulations for many years. One must regard the views expressed by the Tax Court in the long line of coal cases decided

220. *Council of the S. Mountains, Inc. v. Donovan*, 653 F.2d 573 (D.C. Cir. 1981) (limited nature of the rule cannot justify failure to follow notice and comment requirement for a substantive rule).

221. See *supra* text accompanying note 23.

222. Davis points out, "discretionary action [is] unprotected by the safeguards of formal procedure. . . . Judicial review is sometimes available, but much informal action is not even theoretically reviewable and more than ninety-nine percent of what is reviewable is not in fact reviewed." DAVIS TEXT, *supra* note 3, § 4.02, at 91. The scope of review of "formal" tax regulatory actions, on the other hand, probably approaches one hundred percent. *Id.* at § 29.01, at 525.

223. S. REP. No. 752, to accompany S.7 (P.L. 404), 79th Cong., 2d Sess. 15 (1946); H. REP. No. 1980, to accompany S.7 (P.L. 404), 79th Cong., 2d Sess. 25. See also *United States v. Gavrilovic*, 551 F.2d 1099, 1104 n.9 (8th Cir. 1977).

224. See *supra* text accompanying notes 56-60.

since 1983 as the view of a large majority of the nineteen regular judges of the Tax Court.²²⁵ The Claims Court too forfeited an opportunity for clearheadedness when it misread *Anderson, Clayton*.²²⁶ It appears unlikely that the issue will be considered again in the near future.

It took more than forty years from enactment of the APA for the first tax case concerning its relation to the Code to come before a court. Although it would be surprising if another forty years elapses before another case arises, it may be a long while before the court most experienced with the APA, the D.C. Circuit Court of Appeals, considers the issue. Another taxpayer, after losing in the Tax Court, may take his appeal to a circuit other than the Ninth or Eleventh. But as the Circuit with the smallest population, the D.C. Circuit is least likely to be a taxpayer's home circuit. An astute taxpayer might, however, choose to avoid Tax Court by paying any deficiency and suing for a refund. The taxpayer would not wish to sue in the Claims Court but could sue, under federal venue rules, in the D.C. District court and appeal to the D.C. Circuit.

It is quite likely that when Congress adopted the APA in 1946, it believed that there was a fundamental difference in the consequences of characterization of a regulation as legislative rather than interpretive.²²⁷ The legislative history of the APA²²⁸ indicates that while Congress believed an interpretive rule was merely an agency's legal opinion, subject to plenary review, a legislative rule would be upheld if it was not arbitrary or capricious and was rationally related to the purpose of the underlying statute.²²⁹ Since then, however, actual judicial scrutiny has become more searching in the case of legislative regulations but more deferential in the case of interpretive ones.²³⁰ At the same time, the line between interpretive and legislative

225. The Tax Court is a legislative court created by Congress with limited jurisdiction to rule on deficiencies assessed by the government against taxpayers. It does not have the power to review agency action in a declaratory action under 5 U.S.C. § 706. In *Redhouse*, 728 F.2d 1249 (1984), a partial appeal of *Wendland*, 79 T.C. 355 (1982), the Ninth Circuit rejected taxpayer's argument that the Tax Court's decision in *Wendland* was, therefore, void. The Ninth Circuit stated that "[t]he Tax Court was not reviewing agency action in a declaratory relief action under 5 U.S.C. § 706; it was ruling on the amount of a deficiency owed under the specific statutory authorization of I.R.C. § 6214." 728 F.2d 1249, 1253 n.2 (1984). This suggests that the Ninth Circuit views the finding of the Tax Court concerning fulfillment of the notice requirement as dictum. Then the only possible authoritative precedent concerning the interaction of APA section 553 and Code section 7805(b) is that of the Ninth and Eleventh Circuits in the two appeals of *Wendland*. Because the Ninth Circuit held the amendment to the regulations was "interpretive," not "substantive," however, its finding that the thirty-day notice requirement of section 553 of the APA was of doubtful application to Treasury regulations was also dictum. It so found by a circuitous route. The court acknowledged that the original regulation, promulgated pursuant to section 611(a)'s broad grant of legislative authority to issue regulations, was arguably legislative in character. *Redhouse*, *id.* at 1253. The court continues, however, that the amendment was issued to correct an erroneous interpretation of the earlier regulation (contained in two revenue rulings). Since revenue rulings are "classic examples of interpretive rules," "[t]he amendment, changing the Commissioner's revenue rulings, was also of an interpretive nature." *Redhouse*, *id.* at 1253. The appeal was, moreover, subscribed to by a panel of only three judges, Judges Anderson, Schroeder, and Alarcon. *Id.* at 1250. Nevertheless, few taxpayers would voluntarily relitigate the issue in the Ninth Circuit.

226. *Kaiser Cement Corp. v. United States*, 8 Cl. Ct. 34 (1985) misreads *Anderson, Clayton* as making the distinction between legislative and interpretive rulemaking irrelevant for the purpose of according tax regulations retroactive effect. In *Kaiser Cement*, the issue was a retroactive amendment that barred the corporation from changing the accounting period of two controlled foreign subsidiaries to avoid a statutory amendment that would create additional income. *Accord* *Wilson v. United States*, 588 F.2d 1168 (6th Cir. 1978).

227. Asimow, *supra* note 8, at 563.

228. See *supra* note 118; Asimow, *supra* note 8, at 533 n.55, 563.

229. Asimow, *supra* note 8, at 565.

230. *Id.* at 560-61.

regulations has continued to blur. Asimow addresses this issue by stating that,

the expansion of agency power to promulgate legislative rules is a development of extraordinary importance in administrative law. It has left in utter shambles the comfortable notion that interpretive and legislative rules are easy to distinguish by examination of an agency's rule-making power. The traditional view was that a legislative rule could be adopted only pursuant to a *specific* statutory delegation of authority. Rules made pursuant to general rule-making powers were automatically deemed interpretive. Today, however, it is universally accepted that agencies can adopt legislative rules pursuant to general rule-making powers.²³¹

Simultaneously, a number of cases have considered the pragmatic effect of a rule in characterizing it as interpretive or legislative.²³² In sharp contrast to the traditional "legal effects test," the substantial impact test recognizes that even though a rule is merely interpretive of the words in a statute or regulation, it may have substantial impact on the behavior of taxpayers and may sharply alter the consequences of a transaction.²³³

VII. CONCLUSION

The courts' rejection of the applicability of section 553 of the APA to Treasury regulations does not mean that the APA will have no impact on the Treasury and the Internal Revenue Service and their joint administration of the tax law in the future. While the traditional theory that there is a sharp distinction between interpretive and legislative rules appears increasingly indefensible,²³⁴ the consequences of characterization continue to be significant. There is, for example, a fundamental difference in the scope of judicial review of legislative and interpretive rules.²³⁵ Indeed, the

231. *Id.* at 561 (emphasis in original).

232. The other result is, however, that many rules of at least partial legislative (*i.e.*, substantive) impact are introduced or amended without notice or comment procedures. This arises both from greater acceptance of agency power to make legislative rules and greater difficulty in identifying those rules that are legislative. *See id.* at 560-61. In some cases these rules, adopted without extra-agency review, are also not judicially reviewable. *See Eastern Kentucky, supra* notes 199-204, discussed in Asimow, *supra* note 8, at 555.

233. Asimow, *supra* note 8, describes extensively the judicial tests used to distinguish legislative from nonlegislative rules: the legal effect and the substantial impact tests:

The legal effect test is based on a proposition that there exists a fundamental difference in the legal consequences of legislative and nonlegislative agency action. According to this test, legislative rules alter the rights and obligations of members of the public without further action by the agency. Nonlegislative rules, on the other hand, simply describe how the agency intends in the future to interpret law or exercise discretion. Even though nonlegislative rules may have drastic, self-executing effects on behavior, they nevertheless are not "the law." Of course, the most obvious way to ascertain whether a rule affects the public's rights and obligations is to determine how the agency describes its rule; thus the courts rely heavily on the agency's label. But the courts have also been guided by tests suggested by the reports of governmental committees, the legislative history of the APA, and commentators.

Asimow, *supra* note 8, at 531. In contrast are cases that consider the pragmatic effect of the rule as the touchstone for distinguishing legislative from nonlegislative rules. Asimow, *supra* note 8. Asimow then identifies the *Eastern Kentucky* case, 506 F.2d 1290, as one in which the two tests clash. Asimow, *supra* note 8, at 553-56. At the court of appeals level, the court adopted the traditional legal effect test and the majority labelled the ruling interpretive (so that notice and comment procedures were unnecessary). The majority relegated the substantial impact test, which would probably have commanded a different result (the court recognized the impact of the ruling on the poor), to a footnote. Asimow, *supra* note 8, at 554.

234. *See supra* text accompanying notes 200-05.

235. As Davis describes the problem:

legislative history of the APA indicates that one reason Congress exempted interpretive rules from the pre-adoption requirements of the APA was that these rules were thought to be subject to plenary judicial review.²³⁶ As Congress understood the difference in 1946, interpretive rules were merely the agency's legal opinion with which a court was free to disagree. Legislative rules, on the other hand, were thought to be subject to review only to determine if they were arbitrary and capricious and rationally related to the purpose of the underlying statute.²³⁷

Outside the area of tax regulation, courts have increasingly recognized a blurring of the line between interpretive and legislative rules. As a result, a number of cases have required agencies to provide notice and comment procedures before adopting interpretive rules that have a substantial impact.²³⁸ The Tax Court's rejection of the applicability of section 553 to Treasury regulations conflicts with this general trend.²³⁹

In perhaps no other area of federal activity does the regulatory authority have as immediate an impact on the welfare of such a large segment of the population as does the Department of the Treasury in its administration of the Code. Yet it is the agency that has been perhaps the least supervised by the federal courts.

Although several recent cases presented the Tax Court, the Claims Court, and two circuit courts with their first opportunity in more than forty years to analyze the only limitation on the broad grant of administrative authority to Treasury in section 7805 of the Code, the courts failed to establish an integration of the APA and the Code. This failure does more than continue the tradition of granting great deference to an administrative agency. It allows the continued easy application of homily, rather than forcing the agency to reexamine "retroactive" rule-making. If the Treasury need not observe the APA, it need not reexamine old notions of what is substantive and when a nominally prospective rule will, in fact, have significant retroactive impact.

In the context of scope of review, the troublesome subject is determining the degree of authoritative effect of interpretive rules and of rules that are not clearly legislative, including especially tax regulations. In the language of *Batterton v. Francis*, 432 U.S. 416, 425-26 (1977), when Congress delegates power to prescribe standards, "the Secretary adopts regulations with legislative effect," the regulations "are entitled to more than mere deference or weight," and they can be set aside only if the Secretary exceeded his statutory authority or they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." But when no such power is delegated, regulations may be, in the language of *General Electric Co. v. Gilbert*, 429 U.S. 125, 141 (1976), "entitled to consideration in determining legislative intent," but "courts properly may accord less weight to such guidelines than to administrative regulations which Congress has declared shall have the force of law"

5 DAVIS TREATISE, *supra* note 1, § 29:20, at 421.

236. Asimow, *supra* note 8, at 533 n.55.

237. *Id.* at 563 n.193. See *supra* note 118, describing the "arbitrary and capricious" standard applied to some reviews of administrative action.

238. See 2 DAVIS TREATISE, *supra* note 1, § 7:19, at 91-94; Asimow, *supra* note 8, at 561 quoted at text accompanying note 227.

239. Outside the tax regulation area, Davis notes that courts do not fully accept the section 553 exemption for interpretive rules and general statements of policy. 1 DAVIS TREATISE, *supra* note 1, § 6:30, at 594. Rather, he says that the courts have narrowed the exception so that it does not apply to all interpretive rules and general statements of policy. *Id.* For example, it does not apply to rules that have "substantial" impact on those parties affected. *Id.* He also notes that justice may require a notice and a comment procedure when the APA does not and that nothing in the APA is inconsistent with a judicial requirement of these procedures. *Id.* at § 6:31, at 597.

